

NightHawk Radiology Holdings Inc
Form 10-K
March 06, 2007
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2006

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File Number 000-51786

NightHawk Radiology Holdings, Inc.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of incorporation or organization)

250 Northwest Boulevard, #202, Coeur d Alene, Idaho
(Address of principal executive offices)

(208) 676-8321

87-0722777
(IRS Employer Identification No.)

83814
(Zip code)

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Common Stock, par value \$0.001 per share

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark whether the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark whether the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes No

The aggregate market value of the voting stock held by non-affiliates of the registrant outstanding as of February 16, 2007, was \$454 million. As of June 30, 2006 (the last business day of the registrant's most recently completed second fiscal quarter), the aggregate market value of the voting stock held by non-affiliates of the Registrant was \$197 million. Shares of voting stock beneficially held by each officer and director and by each person who owns 5% or more of the outstanding voting stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of February 16, 2007, 29,946,925 shares of the registrant's Common Stock were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Listed hereunder are the documents, any portions of which are incorporated by reference and the Parts of this Form 10-K into which such portions are incorporated:

1. The Registrant's definitive proxy statement for use in connection with the Annual Meeting of Stockholders to be held on or about May 8, 2007 to be filed within 120 days after the Registrant's fiscal year ended December 31, 2006, portions of which are incorporated by reference into Part III of this Form 10-K.
-

Table of Contents

TABLE OF CONTENTS

| | | |
|-----------------|--|----|
| Part I | | |
| | <u>Cautionary Statement</u> | 3 |
| Item 1. | <u>Business</u> | 3 |
| Item 1A. | <u>Risk Factors</u> | 15 |
| Item 1B. | <u>Unresolved Staff Comments</u> | 28 |
| Item 2. | <u>Properties</u> | 28 |
| Item 3. | <u>Legal Proceedings</u> | 28 |
| Item 4. | <u>Submission of Matters to a Vote of Security Holders</u> | 28 |
| Part II | | |
| Item 5. | <u>Market for Registrant's Common Stock, Related Stockholder Matters and Issuer Purchases of Equity Securities</u> | 29 |
| Item 6. | <u>Selected Consolidated Financial Data</u> | 31 |
| Item 7. | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 33 |
| Item 7A. | <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 57 |
| Item 8. | <u>Financial Statements and Supplementary Data</u> | 58 |
| Item 9. | <u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u> | 86 |
| Item 9A. | <u>Controls and Procedures</u> | 86 |
| Item 9B. | <u>Other Information</u> | 86 |
| Part III | | |
| Item 10. | <u>Directors, Executive Officers and Corporate Governance of the Registrant</u> | 87 |
| Item 11. | <u>Executive Compensation</u> | 87 |
| Item 12. | <u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u> | 87 |
| Item 13. | <u>Certain Relationships and Related Transactions and Director Independence</u> | 87 |
| Item 14. | <u>Principal Accounting Fees and Services</u> | 87 |
| Part IV | | |
| Item 15. | <u>Exhibits, Financial Statement Schedules</u> | 88 |
| | <u>Signatures</u> | 92 |

Table of Contents

Cautionary Statement for Purposes of Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995

THIS ANNUAL REPORT CONTAINS FORWARD-LOOKING STATEMENTS THAT INVOLVE RISKS AND UNCERTAINTIES. THE STATEMENTS CONTAINED IN THIS ANNUAL REPORT THAT ARE NOT PURELY HISTORICAL ARE FORWARD-LOOKING STATEMENTS WITHIN THE MEANING OF SECTION 27A OF THE SECURITIES ACT OF 1933, AS AMENDED, AND SECTION 21E OF THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED. THESE FORWARD-LOOKING STATEMENTS INCLUDE, WITHOUT LIMITATION, STATEMENTS RELATING TO FUTURE ECONOMIC CONDITIONS IN GENERAL AND STATEMENTS ABOUT OUR FUTURE:

STRATEGY AND BUSINESS PROSPECTS;

DEVELOPMENT AND EXPANSION OF SERVICES, AND THE SIZE, GROWTH, AND LEADERSHIP OF THE POTENTIAL MARKETS FOR THESE SERVICES;

DEVELOPMENT OF NEW CUSTOMER RELATIONSHIPS AND PRODUCTS;

SALES, EARNINGS, INCOME, EXPENSES, OPERATING RESULTS, TAX RATES, OPERATING AND GROSS PROFIT AND PROFIT MARGINS, VALUATIONS, RECEIVABLES, RESERVES, LIQUIDITY, INVESTMENT INCOME, CURRENCY RATES, EMPLOYEE STOCK OPTION EXERCISES, CAPITAL RESOURCE NEEDS, CUSTOMERS, AND COMPETITION;

ABILITY TO OBTAIN AND PROTECT OUR INTELLECTUAL PROPERTY AND PROPRIETARY RIGHTS; AND

ACQUISITIONS AND TRANSACTION COSTS AND ADJUSTMENTS.

ALL OF THESE FORWARD-LOOKING STATEMENTS ARE BASED ON INFORMATION AVAILABLE TO US ON THE DATE OF THIS ANNUAL REPORT. OUR ACTUAL RESULTS COULD DIFFER MATERIALLY FROM THOSE DISCUSSED IN THIS ANNUAL REPORT. THE FORWARD-LOOKING STATEMENTS CONTAINED IN THIS ANNUAL REPORT, AND OTHER WRITTEN AND ORAL FORWARD-LOOKING STATEMENTS MADE BY US FROM TIME TO TIME, ARE SUBJECT TO CERTAIN RISKS AND UNCERTAINTIES THAT COULD CAUSE ACTUAL RESULTS TO DIFFER MATERIALLY FROM THOSE ANTICIPATED IN THE FORWARD-LOOKING STATEMENTS. FACTORS THAT MIGHT CAUSE SUCH A DIFFERENCE INCLUDE, BUT ARE NOT LIMITED TO, THOSE DISCUSSED IN ITEM 1A OF THIS REPORT ENTITLED RISK FACTORS.

ITEM 1. Business Overview

We believe that we are the leading provider of radiology services to radiology groups and hospitals across the United States. Our team of American Board of Radiology-certified, U.S. state-licensed and hospital-privileged radiologists uses our proprietary workflow technology to provide radiological interpretations, or reads, remotely to our customers in the United States. The reads that we provide consist primarily of off-hours preliminary reads, but also include final and subspecialty interpretations. The preliminary reads we provide are conducted primarily from our centralized reading facilities located in Sydney, Australia and Zurich, Switzerland. By locating our affiliated radiologists in Australia and Switzerland, we can provide off-hours reads to our customers in the United States during our radiologists' local daylight hours while providing our physicians with the ability to work during the day time in a pleasant environment with dedicated support teams. The final and subspecialty reads we provide our customers are conducted by our affiliated radiologists throughout the United States. In 2007, we anticipate opening centralized reading facilities in San Francisco, California and Austin, Texas from which these final and subspecialty reads can be provided.

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-K

Nighthawk Radiology Services, LLC, which is a wholly-owned subsidiary of NightHawk Radiology Holdings, Inc., was formed in Coeur d'Alene, Idaho in 2001 as an Idaho limited liability company and is currently the entity through which we conduct our principal operations. In March 2004, NightHawk Radiology Holdings, Inc. was formed to facilitate a recapitalization of Nighthawk Radiology Services, LLC.

Table of Contents

As of December 31, 2006, our affiliated radiologists provided services to 551 customers serving 1,008 hospitals, or approximately 18% of all hospitals in the United States. Most of these customers do not currently contract for all of the services that we are able to provide. Based on a 2003 survey conducted by the American College of Radiology which estimated the total number of annual reads performed in the United States during all time periods, we believe that we are the leading provider of reads during off-hours periods. Since our first full year of operations, we have experienced significant revenue growth, from \$4.7 million in 2002 to \$92.2 million in 2006.

The U.S. healthcare market is experiencing a substantial increase in the development and use of diagnostic imaging technologies and procedures. This increase is driven by an aging population, advances in diagnostic imaging technologies, the growing availability of imaging equipment in hospitals and clinics and more frequent physician referrals for diagnostic imaging procedures. According to Frost & Sullivan, digital diagnostic image procedure volume is expected to continue to grow 15% annually to over 500 million procedures per year by 2009. Additionally, advances in digital technology now allow for the transmission of radiological images in a high quality, standardized, cost-effective and encrypted format, which permits radiologists to perform a read remotely.

While the volume of diagnostic imaging procedures is expected to grow 15% annually, the number of practicing radiologists is expected to increase by less than 2% annually, according to the American Journal of Roentgenology. This relatively slow growth in radiologists, which is due, in part, to the retirement of existing radiologists and the limited number of positions in accredited radiology residency programs, is expected to exacerbate the radiologist shortage that currently exists. The challenges associated with this shortage and the growing volume of imaging procedures are further compounded by the fact that radiology groups are required to provide their hospital customers with services 24 hours per day, seven days a week, in order to accommodate the growing number of off-hour procedures. Consequently, radiology practice groups and hospitals have begun to seek supplemental services to assist their own radiology staffs with both day and night coverage.

We help our customers manage these challenges by providing an attractive way to increase their productivity and efficiency and improve their quality of life, without sacrificing the quality of patient care. We assist our customers by providing them with access to highly-qualified subspecialty-trained radiologists to perform reads, day or night. Our services include both preliminary reads, which are performed for emergent care purposes, and final and subspecialty reads, which are performed for both emergent and non-emergent care purposes. Our ability to provide coverage 24 hours per day supports our customers when their workloads during the day require further assistance and relieves the burden of performing reads overnight, and during holidays, weekends and other difficult-to-staff times. We believe this allows our customers to provide seamless patient care and to better attract and retain radiologists in their practices.

The substantial majority of the reads that we currently provide are preliminary reads from images generated from hospital emergency departments. These reads are used by the treating physician to determine whether any immediate action is required in response to symptoms being presented by a patient. Typically, the preliminary diagnosis is followed the next morning by a more exhaustive final read performed by a local radiologist affiliated with our customer. Because third-party payors and patients pay only for the final reads performed by our customers and not the preliminary reads that we provide, our services related to these preliminary reads do not result in any incremental costs to third-party payors or patients nor are we currently dependent on payments by them for these reads. All of our customers are located in the United States and, as a result, all of our service revenue to date has been generated from the United States.

In 2006, we began providing our customers with the ability to receive final and subspecialty interpretations in addition to the preliminary reads we have historically provided. This service offering is in response to the needs of our radiology group customers as the growth in imaging continues to put increasing demands on radiologists, requiring radiology groups to work longer hours and/or hire additional radiologists. By offering final and subspecialty read capabilities we can reduce this burden as well as provide our customers with access to our highly-qualified subspecialty-trained radiologists which can help improve the quality of care for our customers' patients and serve as a valuable resource for our customers.

Table of Contents

Also in 2006, we introduced and closed our first sale of TALON, our customer workflow solution. TALON is an internally developed technology platform used by our affiliated radiologists that, along with ongoing IT, quality control and support services we provide, streamlines management of many of the administrative burdens associated with the practice of radiology which, in turn, permits radiologists to focus on the productivity of their practice. By implementing this solution, we believe that our customers can realize some of the same benefits of improved efficiency that we have established in our operations.

Industry Background

Diagnostic Imaging

The practice of diagnostic radiology involves the interpretation of images of the human body to aid in the diagnosis and treatment of diseases, conditions and injuries. Diagnostic imaging procedures include computed tomography, or CT, magnetic resonance imaging, or MRI, ultrasound, nuclear medicine and X-ray technologies. Diagnostic radiologists correlate imaging findings with clinical information and other medical examinations, make diagnoses and may recommend further examinations or treatments.

Due to significant advances in imaging quality and technology, diagnostic imaging procedures are becoming increasingly essential components of the practice of medicine in most medical centers and hospitals. The non-invasive nature of most diagnostic imaging procedures, combined with faster digital processing capabilities and rapid broadband connectivity that allows for the transmission of images to radiology experts, has made the performance of these procedures in the emergency room and in other treatment venues more appealing and practical. As a result, physicians are relying more heavily on imaging procedures and radiological interpretations provided by radiologists as a standard of care to aid in patient care management decisions, resulting in continuing growth in the volume of radiological procedures performed. According to Frost & Sullivan, digital diagnostic image procedure volume is expected to continue to grow 15% annually to over 500 million procedures by 2009.

The diagnostic imaging services industry is expected to continue to grow as a result of:

Positive market dynamics. Increasing physician awareness and utilization of imaging as a standard of care to aid in patient diagnosis, including its use as a preventive screening method, as well as an increased availability of diagnostic imaging equipment in medical centers and hospitals, has fueled the growth of the diagnostic imaging industry. Also, the use of diagnostic imaging procedures has risen with the increased provision of healthcare services generally due to an aging population in the United States. In addition, hospital emergency rooms are increasingly the first point of entry into the healthcare system for patients, resulting in a greater number of radiological procedures being ordered by emergency room physicians. Finally, diagnostic imaging procedures are being ordered more frequently than in the past as physicians seek to better manage medical liability risks by gathering as much data as possible to support their diagnoses and treatment protocols.

Advances in diagnostic imaging technologies. Advances in diagnostic imaging technologies and techniques have resulted in higher quality images, which facilitate the diagnosis of a wide variety of diseases, conditions and injuries quickly and accurately without exploratory surgery or other invasive procedures that are typically more expensive and result in higher risk and rehabilitation time to the patient. New imaging technologies and techniques have also permitted radiologists to make additional diagnoses not previously possible and have resulted in broader applications for diagnostic imaging technologies.

Advances in diagnostic-quality image transmission technologies. The advent of the Digital Imaging and Communications in Medicine, or DICOM, standard for transferring images and associated information, high-speed broadband internet connections, digitization and picture archival and communication systems, or PACS, has contributed to increased utilization of diagnostic imaging technologies by permitting radiologists to practice remotely. As a result of these improvements in image transmission technologies, the time needed for an offsite radiologist to complete a read has generally decreased. Particularly in an emergency room setting, more rapid diagnosis of acute medical problems aids in the prompt identification of patients that need urgent surgery or hospital admission, decreases mortality and morbidity, and reduces healthcare costs by averting unnecessary hospital admissions and surgery.

Table of Contents

Our Solution

We believe we are the leading provider of radiology services to radiology groups and hospitals across the United States. Our team of American Board of Radiology-certified, U.S. state-licensed and hospital-privileged radiologists provides radiological interpretations to our customers in the United States primarily from our reading facilities located in Sydney, Australia, Zurich, Switzerland and the United States.

Key benefits of our solution to radiologists, hospitals and patients include:

Improved efficiency and quality of life for our customers. By using our off-hours, finals and workflow solutions, we believe that our radiology group customers can improve their efficiency. Additionally, by reducing a radiologist's off-hours coverage commitments, we believe that our customers can more effectively recruit and retain highly-qualified radiologists in a competitive job market where such commitments often result in lower job satisfaction.

Enhanced patient care. By providing our customers with access 24 hours per day, seven days a week to highly-qualified subspecialty-trained radiologists to perform reads, we believe that our solutions provide our customers an attractive and economical way to improve service levels, increase the effectiveness of their work environment and enhance the quality of patient care. Additionally, with the improvements in image routing technology and access to broadband connectivity, our services can be efficiently delivered to patients in underserved or rural communities, which are often challenged in recruiting radiologists to practice in their locales, thereby improving the quality of patient care in those communities.

Highly-qualified radiologists. Our affiliated radiologists are American Board of Radiology-certified in the United States and have received their medical training at some of the most respected medical schools in the United States. These radiologists include former chief residents and fellows from Cornell University, Harvard University, New York University, Northwestern University, the University of Pennsylvania, Stanford University and Vanderbilt University. In recognition of the expertise that our affiliated radiologists have developed in emergency radiology, Harvard's Brigham & Women's Hospital has established a program that places their emergency radiology fellows in our Sydney facility in order to train with our affiliated radiologists.

Efficient delivery of services. We have developed proprietary workflow technology that is designed to distribute radiological images and data to the appropriately licensed and privileged radiologist best able to provide the radiological interpretation, including a determination of applicable subspecialty training, in the least amount of turnaround time. As a result of this technology, together with the support provided by our administrative professionals, our affiliated radiologists can better focus on the interpretation of radiological images without the burden of dedicating valuable time to administrative matters, resulting in more efficient delivery of our services to our customers and their patients.

Centralized reading facilities. We deliver our solution primarily from centralized reading facilities located in Sydney, Australia and Zurich, Switzerland. We anticipate opening centralized facilities in San Francisco, California and Austin, Texas during 2007 from which final reads and cardiac imaging services can be provided. By utilizing a centralized approach to the provision of radiology services, we believe that we are able to enhance the quality, efficiency and reliability of the services that we provide to our customers in the following ways:

Quality-control professionals. Our quality-control professionals relieve much of the administrative and technical burden typically associated with a radiology practice by coordinating the communication and transmission of images with the originating hospitals, remediating any technology failures, and finalizing and delivering the results of our affiliated radiologists' reads. By reducing administrative burdens on our affiliated radiologists, our quality-control professionals enable our affiliated radiologists to better focus on the interpretation of radiological images, which we believe enhances the quality and efficiency of our solution.

Table of Contents

Quality-assurance professionals. Our quality-assurance professionals serve as liaisons to our customers and evaluate and respond to any feedback that we may receive. We believe that these professionals enable us to quickly and effectively improve our services in order to respond to the changing needs of our customers.

Collaboration among radiologists. When working in our centralized facilities, our affiliated radiologists are able to collaborate with one another regarding their reads, which we believe can increase the expertise that can be brought to any particular read.

Technology infrastructure and technical-support professionals. Our approach enables us to centrally deploy the computers and servers that comprise our technical infrastructure and to maintain a staff of on-site, technical-support personnel. As a result, we are able to monitor our computer systems and to take appropriate actions to prevent or respond to technical problems quickly and efficiently. We believe that this limits downtime and enhances the reliability of our services. Since our inception, our systems and our online connections to our customers have been operational during more than 99.9% of our service periods.

Key benefits of our business model include:

First-mover advantage. Our early entry into the emerging field of off-hours teleradiology services has permitted us to become well-established with our customers and to establish a brand that we believe has become synonymous with off-hours radiology coverage. As a consequence of the relationships that we have developed with our customers, the current shortage of radiologists, and the burdens associated with licensing and privileging radiologists for a multi-state, multi-hospital practice, we believe that we can leverage our current market position to effectively compete with existing and future market entrants providing preliminary off-hour reads or final reads.

Strong customer retention. Since our formation in 2001, we have secured approximately 418 radiology groups and 133 hospitals as customers. Our customer contracts typically have one-year terms that automatically renew each successive year unless terminated by the customer or by us. Since our inception, more than 96% of our contracts up for renewal have been renewed. We believe that our outstanding customer retention rate confirms the economic and other benefits that our solution provides to our customers and their patients.

Recruitment and retention of radiologists by us. We have been able in the past, and believe that we will continue to be able in the future, to recruit and retain radiologists as necessary to meet increasing demand for our services and the growth of our business. We believe that our success in recruiting and retaining radiologists in a competitive labor market is largely a result of our ability to provide our affiliated radiologists with flexible schedules that permit them to avoid nighttime work and our competitive compensation packages. In addition, we have strategically located our primary reading facilities in Sydney and Zurich in an effort to provide opportunities for radiologists to work during the daytime in attractive, cosmopolitan cities.

Capital-efficient scalability. We have designed our technology, workflow processes and facilities to accommodate continuing growth in our business and the volume of diagnostic images delivered to our affiliated radiologists for interpretation. We believe that we can accommodate future growth in our business in a capital-efficient manner because our fixed costs are a relatively small portion of our expenses and are largely unaffected by the volume of diagnostic images transmitted to our facilities or the distance of the transmissions. In addition, we believe that we can increase our number of affiliated radiologists and associated administrative professionals in a timely manner in response to increased demand for our services.

Licensing and privileging expertise. All of our affiliated radiologists have the necessary licenses and privileges to read the images that are delivered to them, and we have developed a staff of more than 38 full-time professionals dedicated to obtaining and renewing the necessary licenses and privileges. We

Table of Contents

are accredited by the Joint Commission on the Accreditation of Healthcare Organizations, or JCAHO, which permits our customers hospitals, to the extent that they are also JCAHO-accredited, to rely on our internal privileging processes for our affiliated radiologists. This enables us to streamline a privileging process that otherwise can vary significantly among hospitals and to reduce the time required to launch services to a new customer. Our affiliated radiologists are licensed to practice medicine in an average of 37 states and have been granted privileges at an average of 514 hospitals.

Our Strategy

Our objective is to expand on our position as the leading provider of radiology services to radiology groups across the United States. We believe that we have a strong brand and that we have established a position as a leading innovator and thought-leader in the radiology services industry. We intend to capitalize on our brand and reputation to facilitate greater acceptance and expansion of teleradiology services while at the same time improving the overall quality of patient care. Key elements of our strategy include:

Target new customers with expanded sales and marketing efforts. We intend to increase our customer base through a combination of sales and marketing initiatives, continued focus on customer service and the provision of services and technologies that meet our customers' needs. We have 18 direct sales professionals that we employ in order to continue to aggressively target radiology groups of all sizes as well as governmental and military establishments.

Continue to enhance our service offerings. Beginning in 2006, we began expanding our service offerings beyond off-hours emergency services. These services include the provision of final interpretations, cardiac imaging solutions, as well as subspecialty services for modalities and applications that present significant challenges to our customers and that often require interpretation by fellowship-trained radiologists. By implementing our centralized approach in the United States, we believe we will be able to extend the advantages of our teleradiology solution to our radiology group customers 24-hours per day, seven days a week, to assist them in all aspects of their practices. We believe our current customer base of 1,008 hospitals will provide us with an opportunity to grow these new businesses.

Pursue strategic acquisitions. We regularly consider, and intend to continue to pursue, strategic acquisitions that are complementary to our business or offer us other strategic benefits, such as broadening our service offerings, expanding our technology platform or strengthening our position in existing markets. For example, since our inception we have acquired three teleradiology companies, including DayHawk Radiology Services, LLC, American Teleradiology Nighthawks, Inc. and, more recently, Teleradiology Diagnostic Service, Inc.

Develop markets for our data and technology solutions. In 2006, we introduced and closed our first sale of TALON, our customer workflow solution. TALON is an internally developed technology platform used by our affiliated radiologists which, along with the ongoing IT, quality control and support services we provide, streamlines many of the administrative burdens associated with the practice of radiology which, in turn, permits radiologists to focus more on the productivity of their practice. In addition, we are exploring the development and commercialization of data solutions that may be of value to our customers.

Operations

Service Offerings. We currently offer our comprehensive suite of radiology services, including our off-hours preliminary reads, final reads and subspecialty services, to our customers 24-hours per day, seven days a week, including weekends and holidays. The off-hours preliminary services that we provide are conducted by our affiliated radiologists primarily from our centralized reading facilities located in Australia and Switzerland where, due to geographic time differences, they are working during daylight hours. By locating affiliated radiologists in Australia and Switzerland, we can provide off-hours reads in the United States during local daylight hours at our reading facilities.

Table of Contents

In addition to preliminary reads, we provide our customers with final reads, cardiac imaging solutions and subspecialty services. Because final reads must be performed from within the United States to be eligible for reimbursement under Medicare and Medicaid, the final reads we provide are currently conducted by our affiliated radiologists from their homes or home offices throughout the United States. In 2007, we anticipate opening centralized facilities in San Francisco, California and Austin, Texas, from which our final reads and cardiac imaging solutions can be provided.

Affiliated radiologists. As of December 31, 2006, we had 62 affiliated radiologists who were providing services for us. We structure our relationships with our affiliated radiologists in a manner that we believe results in an independent contractor relationship, and we have no control over the radiological services or interpretations rendered by the radiologists or their independent judgment concerning the practice of medicine. We typically enter into two- or three-year professional services contracts with our affiliated radiologists. The contracts typically provide that we will make available a minimum number of hours that the radiologists can work per year and allow the radiologist to specify from which of our reading facilities the radiologist will work. Our contracts also typically provide that the radiologist may perform some work from the radiologist's home in the United States. In each case, the contract is structured so that the radiologist has significant flexibility and control of the radiologist's work schedule. We believe that our affiliated radiologists consider this flexibility an attractive and unique aspect of their relationship with us.

Our goal is to recruit the best radiologists in the United States and to afford them the opportunity to re-locate and work in one of our centralized reading facilities. Our current affiliated radiologists include former chief residents and fellows from Cornell University, Harvard University, New York University, Northwestern University, the University of Pennsylvania, Stanford University and Vanderbilt University. By locating our primary reading facilities in Sydney and Zurich, we believe that we are able to provide opportunities for radiologists to work during the daytime in attractive, cosmopolitan cities. In addition, by utilizing a centralized approach, we offer radiologists the opportunity to work together and collaborate in a professional atmosphere intended to enhance their job satisfaction.

Our affiliated radiologists are required to hold a current license in good standing to practice medicine in each of the states from which they receive radiological images. In addition, our affiliated radiologists are required to have been granted privileges at each hospital from which those images originate. Due to these requirements, and because we were serving more 1,008 hospitals as of December 31, 2006, our affiliated radiologists are licensed to practice medicine in an average of 37 states and have been granted privileges at an average of 514 hospitals.

Network and workflow. We deliver our service solutions through a workflow process that utilizes public network infrastructures, virtual private networks, on-site servers, and proprietary workflow technologies. Our network has been designed to be secure, scalable, efficient and redundant. The following is a description of our workflow process:

Requisition of interpretations. When a radiological procedure is performed on a patient, the radiology technologist at the hospital will order an interpretation by either faxing a requisition to our toll-free telephone number or sending the requisition electronically utilizing our software. The information faxed or sent electronically contains basic patient and procedural information and relevant clinical data. Upon completion of the procedure, the technologist transfers the images to us via an established virtual

Table of Contents

private network, or VPN. Upon receipt of the requisition order and images, one of our designated quality-control professionals sends a digital confirmation of the receipt of the images and order to the technologist at the hospital.

Image transmission. We process all incoming images and patient data at one of our centralized facilities located in Sydney, Australia, Zurich, Switzerland or Coeur d'Alene, Idaho, depending on the time of day. These facilities are connected to hospitals through VPNs, which encrypt the patient and clinical data for secure delivery. Typically, the radiological images are initially transferred to the internet via the hospital's internet service provider. The images and data then traverse the internet through standard networking infrastructure and are automatically directed to one of our reading facilities.

We have designed our networks, server infrastructure, and workflow technologies to be efficient and redundant. In the event of a network or server failure, the originating hospital delivers the images and data set to an assigned radiologist from our radiology group customer. As a result, our processes are intended to ensure that a radiologist is always available to perform the necessary services for the hospital and the patient.

Order acceptance and assignment. After the images and data sets are received at our reading facilities, they are processed for interpretation by our quality-control professionals using our proprietary workflow technology. We employ quality-control professionals who perform many of the administrative functions associated with performing radiological interpretations. These administrative tasks include ensuring the accuracy of patient information, coordinating and communicating with the emergency room and radiology department staff, ensuring the full receipt of the radiological-image data set, using our proprietary workflow solutions to distribute the images to one of our affiliated radiologists, and delivering the results back to the requesting physician.

Interpretation and delivery of report. After the images and data sets have been received by our quality-control professionals, the assigned radiologist interprets the images, dictates his or her findings, reviews the transcription and submits a report back to the designated quality-control professional. The quality-control professional then proofreads the radiologist's report and transmits it back to the requesting physician. After the report has been transmitted, the quality-control professional contacts the originating hospital to confirm that the report has been received. In certain cases, the quality-control professional will verbally communicate the findings to the healthcare professional at the originating hospital.

Quality-assurance processes. We employ quality-assurance professionals whose primary responsibility is to serve as liaisons to our customers. Our quality-assurance professionals also process any feedback from our customers on any discrepancies between the preliminary reads by our affiliated radiologists and the final reads by our customers' radiologists.

Licensing and Privileging

For each hospital from which an affiliated radiologist receives radiological images, the affiliated radiologist must hold a current license in good standing to practice medicine in the state in which the hospital is located and must have been granted privileges to practice at that particular hospital. As a result, and because we were providing services to 1,008 hospitals as of December 31, 2006, we have licensed each of our affiliated radiologists in an average of 37 states and have privileged each of our affiliated radiologists at an average of 514 hospitals. By ensuring that our affiliated radiologists are licensed and privileged at many of our hospital sites, we design redundancy into our solution in order to minimize or eliminate the periods of time during which we do not have an affiliated radiologist available to provide services to a particular hospital.

The licensing procedures and requirements vary according to each state's laws and regulations governing the issuance of medical licenses. These procedures typically include an extensive application process that covers significant aspects of the applicant's professional and personal life. In addition, to maintain a license to practice medicine in a given state, the state will often require the physician to undergo continuing education and training and maintain minimum thresholds of medical liability insurance.

Table of Contents

To facilitate compliance with the licensing requirements of the various states to which we provide services, we employ licensing specialists to manage the state medical license application processes for our affiliated radiologists. These state-licensing specialists perform a number of functions, including tracking expiration dates, implementing procedures to renew licenses, and tracking continuing medical education, medical liability insurance coverage and other ongoing licensing-related obligations.

As with state licensing procedures, the privileging requirements of each hospital can vary significantly. However, hospitals that are accredited under the Joint Commission on Accreditation of Healthcare Organizations, or JCAHO, are permitted to rely upon the privileging information and procedures from other JCAHO-accredited institutions. We have been a JCAHO-accredited entity since October 2003. As a result, JCAHO hospitals can accept our privileging information and procedures, which reduces the period of time before we can begin providing reads for those hospitals.

Technology and Development

Site implementation. After we enter into a contract with a new customer, our site-implementation professionals work with the technology personnel of the hospital that will provide images to us to configure a virtual private network, or VPN, connection and DICOM routing information to transfer images. Upon successful testing of the encryption and transfer of images via the VPN connection, we provide the hospital with written operating procedures that prescribe how to order a radiological interpretation, including through our proprietary online ordering system. Typically, we also conduct a telephonic, workflow training session to educate the appropriate hospital personnel about this process.

Systems and network administration. We employ information technology professionals to maintain our systems and network and to provide technical support to our customers. Our customers may contact us for technical support 24-hours per day, seven days a week.

Software development. We focus our research and development efforts on improving and enhancing our existing workflow solutions as well as on developing new solutions to enable us to more efficiently and effectively deliver our services to our customers. For instance, in 2006, we introduced and closed our first sale of TALON, our customer workflow solution. TALON is an internally developed technology platform used by our affiliated radiologists which, along with ongoing IT, quality control and support services we provide, streamlines many of the administrative burdens associated with the practice of radiology which, in turn, permits radiologists to focus more on the productivity of their practice. These proprietary workflow solutions were developed by software engineers located in our Sydney, Australia and Milwaukee, Wisconsin offices.

Customers

Since our formation in 2001, we have secured approximately 418 radiology groups and 133 hospitals as customers serving 1,008 hospitals. Our customer contracts typically have a one-year term that automatically renews for each successive year unless terminated by the customer or by us. Since our inception, more than 96% of our contracts that have been up for renewal have been renewed. We believe that our customer retention rate confirms the benefits that our solution provides to our customers. We do not have any one customer that represents more than 2% of our annual revenue.

Sales and Marketing

Sales. We sell our services primarily through our direct sales force comprised of 18 telesales and field sales personnel who are organized by geographic regions in the United States. Our sales professionals focus their efforts on radiology groups of all sizes in addition to imaging centers and, in some cases, hospitals. In addition, we have experienced in the past, and expect to experience in the future, the acquisition of new customers as a result of communications among radiology groups. We do not pay any fees or discounts associated with customers who generate new customer leads for us.

Table of Contents

Marketing. Our marketing objectives are to generate qualified sales leads, build our brand and raise awareness of NightHawk as the leading provider of radiology services to radiology groups across the United States.

Our principal marketing initiatives include:

direct mail campaigns,

participation in, and sponsorship of, radiology conferences and trade shows, and

using our website to provide service and company information.

Competition

The market for radiology services is highly competitive, rapidly evolving and fragmented, and subject to changing technology and market dynamics. Our primary competitors include both large and small scale service providers, some of which have only a local or regional presence while others have a more national presence.

We believe the principal competitive factors in our market include:

quality of the service provided,

turnaround time required to complete and return interpretations,

price of services,

reputation of service provider,

number of states and hospitals in which radiologists are licensed and privileged,

market acceptance by radiology groups and hospitals,

quality and reliability of service-provider technology and workflow infrastructure,

quality of customer support,

sales and marketing capabilities of the service provider, and

financial stability of the service provider.

We believe that we compete favorably on these factors. While some of our competitors offer similar types of radiological services to those that we provide, we believe that none of them has been able to capture all of the benefits of our solution. We cannot assure you that our competitors will not offer or develop services that are more attractive than ours or that will achieve greater market acceptance.

Government Regulation and Supervision

General. The healthcare industry is highly regulated. Our ability to operate profitably will depend in part upon the ability of us, our affiliated radiologists, and our customers and their radiologists to obtain and maintain all necessary licenses and other approvals and operate in compliance with applicable healthcare regulations. We believe that healthcare regulations will continue to change. Therefore, we monitor developments in healthcare law and are likely to be required to modify our operations from time to time as the business and regulatory environment changes. Although we believe that we are operating in compliance with applicable federal and state laws, neither our current nor anticipated business operations have been the subject of judicial or regulatory interpretation. We cannot assure you that a review of our business by courts or regulatory authorities will not result in a determination that could adversely affect our operations or that the healthcare regulatory environment will not change in a way that restricts our operations.

Table of Contents

Physician licensure laws. The practice of medicine, including the practice of radiology and teleradiology, is subject to state licensure laws, regulations and approvals. Physicians who provide professional medical services to a patient via a telemedicine system must, in most instances, hold a valid license to practice medicine in the state in which the patient is located. We have established a system for ensuring that our affiliated radiologists are appropriately licensed under applicable state law.

Corporate practice of medicine; fee splitting. The laws of many states, including states in which our customers are located, prohibit us from exercising control over the medical judgments or decisions of our affiliated radiologists and from engaging in certain financial arrangements, such as splitting professional fees with physicians. These laws and their interpretations vary from state to state and are enforced by state courts and regulatory authorities, each with broad discretion. We structure our relationships with our affiliated radiologists and our customers in a manner that we believe is in compliance with prohibitions against the corporate practice of medicine and fee splitting, and in a manner that requires that our affiliated radiologists exercise complete control over their own medical judgments and decisions.

Medicare and Medicaid reimbursement programs. Professional radiology interpretation services performed from a location outside of the United States are generally not reimbursable by the Medicare program and certain state Medicaid programs. Accordingly, we do not bill Medicare or Medicaid programs for professional services performed by our affiliated radiologists located outside of the United States. Instead, our revenue is primarily derived from service fees paid to us by our customer radiology groups and hospitals. As a result, our service fees do not fluctuate or change based solely on changes in Medicare or Medicaid reimbursement levels.

Federal and state anti-kickback prohibitions. Various federal and state laws govern financial arrangements among healthcare providers. The federal anti-kickback law prohibits the knowing and willful offer, payment, solicitation or receipt of any form of remuneration in return for, or with the purpose to induce, the referral of Medicare, Medicaid, or other federal healthcare program patients, or in return for, or with the purpose to induce, the purchase, lease or order of items or services that are covered by Medicare, Medicaid, or other federal healthcare programs. Similarly, many state laws prohibit the solicitation, payment or receipt of remuneration in return for, or to induce the referral of patients in private as well as government programs. Violation of these anti-kickback laws may result in substantial civil or criminal penalties for individuals or entities and/or exclusion from participating in federal or state healthcare programs. We believe that we are operating in compliance with applicable federal and state anti-kickback laws and that our contractual arrangements with our customers are structured in a manner that is compliant with such laws.

Health Insurance Portability and Accountability Act of 1996. HIPAA authorizes the imposition of civil money penalties against entities that employ or enter into contracts with individuals or entities that have been excluded from participation in the Medicare or Medicaid programs. We perform background checks on our affiliated radiologists, and do not believe that we employ or contract with any excluded individuals or entities. However, a finding that we have violated this provision of HIPAA could have a material adverse effect on our business and financial condition.

HIPAA also established several separate criminal penalties for making false or fraudulent claims to insurance companies and other non-governmental payors of healthcare services. These provisions are intended to punish some of the same conduct in the submission of claims to private payors as the Federal False Claims Act covers in connection with governmental health programs. We believe that our services have not historically been provided in a way that would place either our clients or ourselves at risk of violating the HIPAA anti-fraud statutes. We could be vulnerable to prosecution under these statutes if any of our customers deliberately or recklessly submits claims that contain false, misleading or incomplete information.

In addition, the Administrative Simplification provisions of HIPAA require the promulgation of regulations establishing national standards for, among other things, certain electronic healthcare transactions, the use and disclosure of certain individually identifiable patient health information, and the security of the electronic systems maintaining this information. These are commonly known as the HIPAA transaction and code set standards, privacy standards, and security standards, respectively.

Table of Contents

The administrative provisions of HIPAA direct the federal government to adopt national electronic standards for automated transfer of certain healthcare data among healthcare payors, plans and providers. HIPAA is designed to enable the entire healthcare industry to communicate electronic data using a single set of standards. We are a covered entity under HIPAA and, as such, we must operate in compliance with the electronic transaction code standards, privacy standards and security standards. Further, because we only provide treatment services to patients of our contracted radiology groups and hospitals that are either independent or jointly provided with services rendered by those entities, we do not fall within the definition of a business associate. A business associate is an entity that performs services for or on behalf of a covered entity and is required to enter into an agreement with that covered entity to comply with certain components of the HIPAA administrative simplification provisions. We have developed policies, procedures and systems for handling patient health information that we believe are in compliance with the requirements of HIPAA.

In addition to HIPAA, Australia and many U.S. states have adopted statutes and regulations that are similar to or, in some cases, more stringent than HIPAA. We believe that our operations are consistent with these statutes and regulations.

Federal Deficit Reduction Act of 2005. The Federal Deficit Reduction Act of 2005, or the DRA, requires that medical providers receiving more than \$5,000,000 in annual Medicaid payments from a specific state must establish certain written policies to be disseminated to that provider's employees, contractors and agents. The written policies required by the DRA include information about the Federal False Claims Act, administrative remedies under the Program Fraud Civil Remedies Act, state and local laws regarding false claims for those localities in which the practice operates, and the protections given to whistleblowers under such laws. We believe that we are not currently subject to the informational and educational mandates of the DRA because we do not now receive more than the requisite amount of Medicaid payments from any state.

Intellectual Property

Our principal intellectual property assets include our brand and our proprietary software technology. We rely primarily on trade secret and unfair competition laws in the United States and other jurisdictions as well as confidentiality procedures and contractual provisions to protect these assets. We believe that the name NightHawk cannot be afforded trademark protection as it is a generic term used to describe the provision of off-hours radiology services. However, we intend to pursue all protections available, including common law claims for unfair competition practices, for improper use of the NightHawk name. We also hold the registered trademark DayHawk, which is used internally to represent our hours of coverage during weekends and holidays.

In addition to our trade names, we have filed one patent application covering certain aspects of our proprietary workflow technology.

We enter into confidentiality and proprietary rights agreements with our employees, affiliated radiologists, consultants and other third parties and control access to software, documentation and other proprietary information.

If a claim is asserted that we have infringed the intellectual property of a third party, we may be required to seek licenses to that technology. In addition, we license third-party technologies that are incorporated into some elements of our services. Licenses from third-party technologies may not continue to be available to us at a reasonable cost, or at all. Additionally, the steps we have taken to protect our intellectual property rights may not be adequate. Third parties may infringe or misappropriate our proprietary rights. Competitors may also independently develop technologies that are substantially equivalent or superior to the technologies we employ in our services. If we fail to protect our proprietary rights adequately, our competitors could offer similar services, potentially significantly harming our competitive position and decreasing our revenue.

Table of Contents

Employees and Independent Contractors

As of December 31, 2006, we had 223 employees. In addition, as of December 31, 2006, we had 62 affiliated radiologists who provide services to our customers. None of our employees is represented by a labor union. We consider our relationships with our employees and independent contractors to be good.

Website

Our website address is www.nighthawkrad.net and can be used to access, free of charge, through the investor relations category, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports, as soon as reasonably practicable after we electronically file such material with or furnish it to the SEC. The information on our website is not incorporated as a part of this annual report. The public can also obtain copies of these reports by visiting the SEC's Public Reference Room at 100 F Street, NE, Washington DC 20549, or by calling the SEC at 1-800-SEC-0330, or by accessing the SEC's website at <http://www.sec.gov>.

ITEM 1A. Risk Factors

YOU SHOULD CAREFULLY CONSIDER THE RISKS DESCRIBED BELOW BEFORE MAKING AN INVESTMENT DECISION. OUR BUSINESS, PROSPECTS, FINANCIAL CONDITION OR OPERATING RESULTS COULD BE MATERIALLY ADVERSELY AFFECTED BY ANY OF THESE RISKS, AS WELL AS OTHER RISKS NOT CURRENTLY KNOWN TO US OR THAT WE CURRENTLY DEEM IMMATERIAL. THE TRADING PRICE OF OUR COMMON STOCK COULD DECLINE DUE TO ANY OF THESE RISKS AND YOU MAY LOSE ALL OR PART OF YOUR INVESTMENT. IN ASSESSING THE RISKS DESCRIBED BELOW, YOU SHOULD ALSO REFER TO THE OTHER INFORMATION CONTAINED IN THIS REPORT, INCLUDING OUR CONSOLIDATED FINANCIAL STATEMENTS AND THE RELATED NOTES, BEFORE DECIDING TO PURCHASE ANY SHARES OF OUR COMMON STOCK.

We have a short operating history in an emerging market, which makes it difficult to evaluate our business and prospects.

We have a short operating history in an emerging market. As a result, our current business and future prospects are difficult to evaluate. You must consider our business and prospects in light of the risks and difficulties we encounter as an early-stage company in a rapidly evolving market. Some of these risks relate to our potential inability to:

effectively manage our business and technology,

develop new services that complement our existing business,

acquire additional customers,

successfully provide high levels of service quality as we expand the scale of our business,

manage rapid growth in personnel and operations,

effectively manage our medical liability risk,

market our services to our customers due to regulatory rules governing reassignment of payments, which could affect our customers ability to collect fees for services provided by our affiliated radiologists, and

recruit and retain radiologists and other key personnel.

We may not be able to successfully address these and the other risks described in this report. Failure to adequately do so would harm our business and cause our operating results to suffer. Furthermore, our limited operating history has resulted in revenue growth rates that we may not be able to sustain, and therefore may not be indicative of our future results of operations. As a result, the price of our common stock could decline.

Table of Contents

The market in which we participate is competitive and we expect competition to increase in the future, which will make it more difficult for us to sell our services and may result in pricing pressure, reduced revenue and reduced market share.

The market for teleradiology is competitive and rapidly changing, barriers to entry are relatively low, and with the introduction of new technologies and market entrants, we expect competition to intensify in the future. If we fail to compete effectively, our operating results will be harmed. Some of our principal competitors offer their services at a lower price, which has resulted and will continue to result in pricing pressure. If we are unable to maintain our current pricing, our operating results could be negatively impacted. In addition, pricing pressures and increased competition could result in reduced revenue, reduced profits or the failure of our service to achieve or maintain more widespread market acceptance, any of which could harm our business.

In addition, if one or more of our competitors were to merge or partner with another of our competitors, or if companies larger than we are enter the market through internal expansion or acquisition of one of our competitors, the change in the competitive landscape could adversely affect our ability to compete effectively. These competitors could have established customer relationships and greater financial, technical, sales, marketing and other resources than we do, and could be able to respond more quickly to new or emerging technologies or devote greater resources to the development, promotion and sale of their services. This competition could harm our ability to sell our services, which may lead to lower prices, reduced revenue and, ultimately, reduced market share.

If our arrangements with our affiliated radiologists or our customers are found to violate state laws prohibiting the corporate practice of medicine or fee splitting, our business, financial condition and our ability to operate in those states could be adversely impacted.

The laws of many states, including states in which our customers are located, prohibit us from exercising control over the medical judgments or decisions of physicians and from engaging in certain financial arrangements, such as splitting professional fees with physicians. These laws and their interpretations vary from state to state and are enforced by state courts and regulatory authorities, each with broad discretion. We enter into agreements with our affiliated radiologists pursuant to which the radiologists render professional medical services. In addition, we enter into agreements with our customers to deliver professional radiology interpretation services in exchange for a service fee. We structure our relationships with our affiliated radiologists and our customers in a manner that we believe is in compliance with prohibitions against the corporate practice of medicine and fee splitting. While we have not received notification from any state regulatory or similar authorities asserting that we are engaged in the corporate practice of medicine or that the payment of service fees to us by our customers constitutes fee splitting, if such a claim were successful, we could be subject to civil and criminal penalties and could be required to restructure or terminate the applicable contractual arrangements. A determination that these arrangements violate state statutes, or our inability to successfully restructure our relationships with our affiliated radiologists to comply with these statutes, could eliminate customers located in certain states from the market for our services, which would have a materially adverse effect on our business, financial condition and operations.

We may be unable to successfully expand our services beyond the off-hours emergency radiology market.

We have historically focused our business on providing emergency radiology services during the hours of 5:00 p.m. to 8:00 a.m. and 24-hours per day on weekends and holidays. In 2006, we expanded our hours of service to 24-hours per day, seven days a week and began offering final reads and subspecialty services, including cardiac imaging services, to enhance our service offerings to our customers. However, our efforts to provide these final reads and subspecialty services, or any other markets beyond our current services offerings, may not result in significant revenue growth for us. In addition, efforts to expand our services into these new markets may divert management resources from existing operations and require us to commit significant financial resources to an unproven business. To support these service offerings, we anticipate opening two additional centralized reading centers in San Francisco, California and Austin, Texas, similar to our facilities in Sydney, Australia and Zurich, Switzerland. If we are unable to effectively and profitably expand our offerings in these areas, our business, financial condition and results of operations could be adversely affected.

Table of Contents

If our affiliated radiologists are characterized as employees, we would be subject to employment and withholding liabilities and may be subject to prohibitions against the corporate practice of medicine.

We structure our relationships with our affiliated radiologists in a manner that we believe results in an independent contractor relationship, not an employee relationship. An independent contractor is generally distinguished from an employee by his or her degree of autonomy and independence in providing services. A high degree of autonomy and independence is generally indicative of a contractor relationship, while a high degree of control is generally indicative of an employment relationship. Although we believe that our affiliated radiologists are properly characterized as independent contractors, tax or other regulatory authorities may in the future challenge our characterization of these relationships. If such regulatory authorities or state, federal or foreign courts were to determine that our affiliated radiologists are employees, and not independent contractors, we would be required to withhold income taxes, to withhold and pay social security, Medicare and similar taxes and to pay unemployment and other related payroll taxes. We would also be liable for unpaid past taxes and subject to penalties. In addition, such a determination may also result in a finding that we are engaged in the corporate practice of medicine in violation of the laws of many states. As a result, any determination that our affiliated radiologists are our employees would materially harm our business and operating results.

If we acquire any companies or technologies in the future, they could prove difficult to integrate, disrupt our business, dilute stockholder value and adversely affect our operating results.

A key element of our strategy is to pursue strategic acquisitions that are complementary to our business or offer us other strategic benefits. Acquisitions in which we may engage involve numerous risks, including:

difficulties in integrating operations, technologies, services and personnel,

diversion of financial and management resources from existing operations,

risk of entering new markets,

potential write-offs of acquired assets,

potential loss of key employees, and

inability to generate sufficient revenue to offset acquisition costs.

We may experience these difficulties as we integrate the operations of future companies we acquire with our operations.

In addition, if we finance acquisitions by issuing convertible debt or equity securities, our existing stockholders may be diluted which could affect the market price of our stock. Including the recently-closed acquisition of Teleradiology Diagnostic Service, Inc., we have made three acquisitions to date, and our management has limited experience in completing acquisitions and integrating acquired businesses with our operations. If we fail to properly evaluate and execute acquisitions, our business and prospects may be harmed.

Our growth strategy depends on our ability to recruit and retain qualified radiologists and other skilled personnel. If we are unable to do so, our future growth would be limited and our business and operating results would be harmed.

Our success is dependent upon our continuing ability to recruit and retain qualified radiologists. An inability to recruit and retain radiologists would have a material adverse effect on our ability to grow and would adversely affect our results of operations. We face competition for radiologists from other healthcare providers, including radiology groups, research and academic institutions, government entities and other organizations. In addition, our affiliated radiologists are typically U.S. citizens who must obtain visas to work in Australia or Switzerland. We have worked with the government of Australia to establish a visa program and have assisted our affiliated radiologists in the visa application process with the government of Switzerland, and to date all of our professionals have successfully obtained work visas in a timely manner.

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-K

However, any future inability to obtain or difficulty in obtaining work visas for our affiliated radiologists, due to changing immigration regulations or otherwise, would jeopardize our business and harm our results.

Table of Contents

In addition to recruiting radiologists, we must identify, recruit and retain skilled executive, technical, administrative, sales, marketing and operations personnel for our headquarters in Coeur d'Alene, Idaho. Competition for highly qualified and experienced personnel is intense due to the limited number of people available with the necessary skills. In addition, Coeur d'Alene has a relatively small pool of potential employees with the skills that we require, and is a small city in a relatively rural part of the country, making it difficult for us to recruit employees from larger metropolitan areas of the country. Failure to attract and retain the necessary personnel would inhibit our growth and harm our business.

We have been subject to medical liability claims and may become subject to additional claims, which could cause us to incur significant expenses and may require us to pay significant damages if not covered by insurance.

Our business entails the risk of medical liability claims against our affiliated radiologists and us. We or our affiliated radiologists are subject to ongoing medical liability claims in the ordinary course of business. In the past, we have been subject to a medical liability claim for which a settlement was paid by our insurance carrier and we are likely to be subject to future claims which will involve payment or settlement. Although we maintain medical liability insurance for ourselves and our affiliated radiologists with coverage that we believe are appropriate in light of the risks attendant to our business, successful medical liability claims could result in substantial damage awards which exceed the limits of our insurance coverage. In addition, medical liability insurance is expensive and insurance premiums may increase significantly in the future, particularly as we expand our services to include final and subspecialty reads and cardiac imaging services. As a result, adequate medical liability insurance may not be available to our affiliated radiologists or us in the future at acceptable costs or at all.

Any claims made against us that are not fully covered by insurance could be costly to defend against, result in substantial damage awards against us and divert the attention of our management and our affiliated radiologists from our operations, which could adversely affect our operations and financial performance. In addition, any claims might adversely affect our business or reputation.

We indemnify our radiology group and hospital customers against damages or liabilities that they may incur as a result of the actions of our affiliated radiologists or us. We also indemnify some of our affiliated radiologists against medical liability claims. Our indemnification obligations are typically payable only to the extent that damages incurred are not covered by insurance.

We have also assumed and succeeded to substantially all of the obligations of the businesses that we have acquired. Medical liability claims may be asserted against us for events that occurred prior to these acquisitions. In connection with our acquisitions, the sellers of the businesses that we have acquired have agreed to indemnify us for certain claims. However, we may not be able to collect payment under these indemnity agreements, which could affect us adversely.

Our customers may terminate their agreements with us, or their agreements with the hospitals that they serve may be terminated, either of which could adversely affect our financial condition and operating results.

Our revenue is derived primarily from fee-for-service billings to our radiology group customers. Our agreements with our customers generally provide for one-year terms and automatically renew for successive one-year terms unless terminated by our customers or us upon 30 days' prior notice. Following the first anniversary of the agreements, the agreements typically may be terminated at any time by our customers or us upon 60 days' prior notice. Our customers may elect not to renew their contracts with us, they may seek to renegotiate the terms of their contracts or they may choose to reduce or eliminate our services in the future. If our arrangements with our customers are canceled, or are not renewed or replaced with other arrangements having at least as favorable terms, our business, financial condition and results of operations could be adversely affected. In addition, to the extent that our radiology group customers' agreements with the hospitals that they serve are terminated, our business, financial condition and results of operations could be adversely affected.

Table of Contents

Enforcement of federal and state laws regarding privacy and security of patient information may adversely affect our business, financial condition or operations.

The use and disclosure of certain healthcare information by healthcare providers and their business associates have come under increasing public scrutiny. Recent federal standards under the Health Insurance Portability and Accountability Act of 1996, or HIPAA, establish rules concerning how individually-identifiable health information may be used, disclosed and protected. Historically, state law has governed confidentiality issues and HIPAA preserves these laws to the extent they are more protective of a patient's privacy or provide the patient with more access to his or her health information. As a result of the implementation of the HIPAA regulations, many states are considering revisions to their existing laws and regulations that may or may not be more stringent or burdensome than the federal HIPAA provisions. We must operate our business in a manner that complies with all applicable laws, both federal and state and that does not jeopardize the ability of our customers to comply with all applicable laws to which they are subject. We believe that our operations are consistent with these legal standards. Nevertheless, these laws and regulations present risks for healthcare providers and their business associates that provide services to patients in multiple states. Because these laws and regulations are recent and few have been interpreted by government regulators or courts, our interpretations and activities may be challenged. If a challenge to our activities is successful, it could have an adverse effect on our operations, may require us to forgo relationships with customers in certain states, and may restrict the territory available to us to expand our business. In addition, even if our interpretations of HIPAA and other federal and state laws and regulations are correct, we could be held liable for unauthorized uses or disclosures of patient information as a result of inadequate systems and controls to protect this information or due to the theft of information by unauthorized computer programmers who penetrate our network security.

Our business could be adversely affected if additional patient privacy restrictions are imposed through federal or state legislation or regulation.

On April 14, 2005, U.S. Senator Hillary Clinton and U.S. Representative Edward Markey reintroduced legislation that, if enacted, would prohibit healthcare organizations from sharing patient information with foreign affiliates or subcontractors without first obtaining consent from patients. A similar type of provision was proposed, but was not enacted, in the 2004 California legislative session. If a provision such as this were passed, it could impede our ability to obtain service contracts with radiology group practices or hospitals, as those providers would be required to obtain patient consent prior to transmitting the patient's information to any of our reading facilities located outside of the United States.

Future changes in healthcare regulation are difficult to predict and may constrain or require us to restructure our operations, which could negatively impact our business and operating results.

The healthcare industry is heavily regulated and subject to frequent changes in governing laws and regulations as well as to evolving administrative interpretations. Our business could be adversely affected by regulatory changes at the federal or state level that impose new requirements for licensing, new restrictions on reimbursement for medical services by government programs, new pretreatment certification requirements for patients seeking radiology procedures, or new limitations on services that can be performed by us. In addition, federal, state and local legislative bodies have adopted and continue to consider medical cost-containment legislation and regulations that have restricted or may restrict reimbursement to entities providing services in the healthcare industry and referrals by physicians to entities in which the physicians have a direct or indirect financial interest or other relationship. For example, Medicare recently adopted a regulation that limits the technical component of the reimbursement for multiple diagnostic tests performed during a single session at medical facilities other than hospitals. Any of these or future reimbursement regulations or policies could limit the number of diagnostic tests our customers order and could have a material adverse effect on our business.

Although we monitor legal and regulatory developments and modify our operations from time to time as the regulatory environment changes, we may not be able to adapt our operations to address every new regulation, and such regulations may adversely affect our business. In addition, although we believe that we are operating in

Table of Contents

compliance with applicable federal and state laws, our business operations have not been scrutinized or assessed by judicial or regulatory agencies. We cannot assure you that a review of our business by courts or regulatory authorities would not result in a determination that adversely affects our operations or that the healthcare regulatory environment will not change in a way that will restrict our operations.

Our growth and our continued operations as a publicly-traded company could strain our personnel, management and infrastructure resources, which may harm our business.

We are currently experiencing a period of rapid growth in our headcount and operations, including, in particular, the opening of our first U.S.-based centralized facilities in the first quarter of 2007, which has placed, and will continue to place, a significant strain on our management, administrative, operational and financial infrastructure. We also anticipate that further growth will be required to address increases in the scope of our operations and size of our customer base. Our success will depend in part upon the ability of our current senior management team to manage this growth, as well as to manage our operations as a publicly-traded company effectively.

To effectively manage our anticipated growth, we will need to continue to improve our operational, financial and management processes and controls and our reporting systems and procedures. In addition, the additional headcount we are adding and capital investments we are making will increase our costs, which will make it more difficult for us to offset any future revenue shortfalls by offsetting expense reductions in the short term. If we fail to successfully manage our growth and our operations as a publicly-traded company, our business and operating results will be harmed.

Our operating results are subject to seasonal fluctuation, which makes our results difficult to predict and could cause our performance to fall short of quarterly expectations.

We have experienced increased demand for and revenues from our services during the second and third fiscal quarters of each year. We believe that these increases are a result of increased outdoor and transportation activities during summer months. During the first and fourth quarters of each fiscal year, when weather conditions are colder for a large portion of the United States, we have historically experienced relatively lower revenues than those experienced during the second and third quarters. We may continue to experience this or other seasonality in the future. These seasonal factors may lead to unpredictable variations in our quarterly operating results and cause the trading price of our common stock to decline. Additionally, our ability to schedule adequate radiologist coverage during the seasonal period of increased demand for our services may affect our ability to provide faster turnaround times in our services to clients.

Interruptions or delays in our information systems or in network or related services provided by third-party suppliers could impair the delivery of our services and harm our business.

Our operations depend on the uninterrupted performance of our information systems, which are substantially dependent on systems provided by third parties over which we have little control. Failure to maintain reliable information systems, or disruptions in our information systems could cause disruptions and delays in our business operations which could have a material adverse effect on our business, financial condition and results of operations.

We rely on broadband connections provided by third party suppliers to route digital images from hospitals in the United States to our facilities in Australia, Switzerland and Coeur d'Alene, Idaho. Any interruption in the availability of the network connections between the hospitals and our reading facilities would reduce our revenue and profits. Frequent or persistent interruptions in our services could cause permanent harm to our reputation and brand and could cause current or potential customers to believe that our systems are unreliable, leading them to switch to our competitors. Because our customers may use our services for critical healthcare services, any system failures could result in damage to our customers' businesses and reputation. These customers could seek significant compensation from us for their losses, and our agreements with our customers do not limit the amount of compensation that they may receive. Any claim for compensation, even if unsuccessful, would likely be time consuming and costly for us to resolve.

Table of Contents

Although our systems have been designed around industry-standard architectures to reduce downtime in the event of outages or catastrophic occurrences, they remain vulnerable to damage or interruption from earthquakes, floods, fires, power loss, telecommunication failures, terrorist attacks, computer viruses, break-ins, sabotage, and acts of vandalism. In addition, the connections from hospitals to our reading facility in Australia rely on two cables that link the west coast of the United States with Australia. Despite any precautions that we may take, the occurrence of a natural disaster or other unanticipated problems at our reading facilities or in the networks that connect our reading facilities with our hospitals could result in lengthy interruptions in our services. We do not carry business interruption insurance to protect us against losses that may result from interruptions in our service as a result of system failures.

Hospital privileging requirements or physician licensure laws may limit our market, and the loss of hospital privileges or state medical licenses held by our affiliated radiologists could have a material adverse affect on our business, financial condition and results of operations.

Each of our affiliated radiologists must be granted privileges to practice at each hospital from which the radiologist receives radiological images and must hold a license in good standing to practice medicine in the state in which the hospital is located. The requirements for obtaining and maintaining hospital privileges and state medical licenses vary significantly among hospitals and states. If a hospital or state restricts or impedes the ability of physicians located outside of the United States to obtain privileges or a license to practice medicine at that hospital or in that state, the market for our services could be reduced. In addition, any loss of existing privileges or medical licenses held by our affiliated radiologists could impair our ability to serve our existing customers and have a material adverse affect on our business, financial condition and results of operations.

Medicare and Medicaid rules governing reassignment of payments could affect our customers' ability to collect fees for services provided by our affiliated radiologists and our ability to market our services to our customers.

The majority of our customers are radiology practices. These customers, and not us, bill and receive payments from Medicare and/or Medicaid for the final and subspecialty reads provided by our affiliated radiologists. Medicare and Medicaid generally prohibit a physician who performs a covered medical service from reassigning to anyone else (including to other physicians) the performing physician's right to receive payment directly from Medicare or Medicaid, except in certain circumstances. We believe that the final and subspecialty reads provided by our affiliated radiologists satisfy one or more of the exceptions to this prohibition, but the various Medicare carriers and state Medicaid authorities may interpret these exceptions differently than we do. Because Medicare and Medicaid payments may comprise a significant portion of the total payments received by our customers for the services of our affiliated radiologists, if it were determined that we do not qualify for an exception, our customers could be prohibited from billing Medicare and/or Medicaid for the services of our affiliated radiologists and this would cause a material adverse effect on our ability to market our services and on our business and results of operations. Future laws or regulations, moreover, may require that we bill Medicare or Medicaid directly for the services we provide to our customers. Should this occur, we would either be required to forgo business with such customers or be required to design, develop and implement an appropriate recordkeeping and billing system to bill Medicare and Medicaid.

Changes in the rules and regulations governing Medicare's and Medicaid's payment for medical services could affect our revenues, particularly with respect to final reads.

Although most reads we provide are preliminary reads rather than final reads, we are providing an increasing number of final and subspecialty reads cardiac imaging services. Cost-containment pressures on Medicare and Medicaid could result in a reduction in the amount that the government will pay for these reads, which could cause pricing pressure on our services. Should that occur, we could be required to lower our prices, or our customers could elect to provide the reads themselves or obtain such services from one of our competitors, and not utilize the services of our affiliated radiologists, which would have a material adverse effect on our business, results of operations and financial condition.

Table of Contents

We may be subject to less favorable levels of payment based upon third party payor fee schedules.

Many patients are covered by some form of private or government health insurance or other third party payment program. Third party payors generally establish fee schedules or other payment authorization methods for various procedures that govern which procedures will be reimbursed by the third party payors and the amount of reimbursement. To the extent that such schedules impact the rates at which third party payors are willing to pay the healthcare providers with whom we contract to provide imaging services, we are indirectly impacted by such fee schedules. However, if we were to negotiate direct payment arrangements with third party payors in the future, we would be directly impacted by such schedules. In addition, there is no guarantee that Medicare, state Medicaid programs, or commercial third party payors will continue to cover teleradiology services. Any reduction or elimination in coverage for our services could adversely impact our business.

Our business could be materially affected if a U.S. Department of Health & Human Services Office of Inspector General study results in a recommendation that Medicare only pay for reads performed contemporaneously in an emergency room setting.

In its Fiscal Year 2004 Work Plan, the U.S. Department of Health & Human Services Office of Inspector General, or HHS-OIG, indicated that it would conduct a study and issue a report assessing the appropriateness of Medicare billings for diagnostic tests performed in hospital emergency rooms. Part of the assessment will include a determination as to whether the tests were read contemporaneously with the patient's treatment. It is possible that, in the final report, the HHS-OIG could recommend to CMS that it change its reimbursement rules to clearly indicate that CMS will only pay for reads performed contemporaneously with a patient's treatment by a physician located within the United States. If CMS were to adopt this recommendation, final reads would no longer be eligible for reimbursement if performed by a physician other than the one who performed the preliminary read. In turn, if our customers were no longer able to be reimbursed for certain final reads, our customers may seek alternative arrangements for the performance of their preliminary reads, which could adversely impact our business.

Changes in the healthcare industry or litigation reform could reduce the number of diagnostic radiology procedures ordered by physicians, which could result in a decline in the demand for our services, pricing pressure and decreased revenue.

Changes in the healthcare industry directed at controlling healthcare costs and perceived over-utilization of diagnostic radiology procedures could reduce the volume of radiological procedures performed. For example, in an effort to contain increasing imaging costs, some managed care organizations and private insurers are instituting pre-authorization policies which require physicians to pre-clear orders for diagnostic radiology procedures before those procedures can be performed. If pre-clearance protocols are broadly instituted throughout the healthcare industry, the volume of radiological procedures could decrease, resulting in pricing pressure and declining demand for our services. In addition, it is often alleged that many physicians order diagnostic procedures even when the procedures may have limited clinical utility in large part to establish a record for defense in the event of a medical liability claim. Changes in tort law could reduce the number of radiological procedures ordered for this purpose and therefore reduce the total number of radiological procedures performed each year, which could harm our operating results.

We may not have adequate intellectual property rights in our brand, which could limit our ability to enforce such rights.

Our success depends in part upon our ability to market our services under the NightHawk brand. However, we believe that the term NightHawk cannot be afforded trademark protection as it is a generic term used to describe the provision of off-hours radiology services. Other than TALON and DayHawk, we have not secured registrations of our other marks. Other businesses may have prior rights in the brand names that we market under or in similar names, which could limit or prevent our ability to use these marks, or to prevent others

Table of Contents

from using similar marks. If we are unable to prevent others from using our brand names, or if others prohibit us from using them, our revenue could be adversely affected. Even if we are able to protect our intellectual property rights in such brands, we could incur significant costs in doing so.

Any failure to protect our intellectual property rights in our workflow technology could impair its value and our competitive advantage.

We rely heavily on our proprietary workflow technology to distribute radiological images to the appropriately licensed and privileged radiologist best able to provide the necessary clinical insight in the least amount of turnaround time. If we fail to protect our intellectual property rights adequately, our competitors may gain access to our technology, and our business may be harmed. We currently do not hold any patents with respect to our technology. Although we have filed an application for a patent covering our workflow technology, we may be unable to obtain patent protection for this technology. In addition, any patents we may obtain may be challenged by third parties. Accordingly, despite our efforts, we may be unable to prevent third parties from using or misappropriating our intellectual property.

We may in the future become subject to intellectual property rights claims, which could harm our business and operating results.

The information technology industry is characterized by the existence of a large number of patents, trademarks and copyrights and by frequent litigation based on allegations of infringement or other violations of intellectual property rights. If a third party asserts that our technology violates that third-party's proprietary rights, or if a court holds that our technology violates such rights, we may be required to re-engineer our technology, obtain licenses from third parties to continue using our technology without substantial re-engineering or remove the infringing functionality or feature. In addition, we may incur substantial costs defending any such claim. We may also become subject to damage awards, which could cause us to incur additional losses and harm our financial position.

Monitoring potential infringement of and defending or asserting our intellectual property rights may entail significant expense. We may initiate claims or litigation against third parties for infringement of our proprietary rights or to establish the validity of our proprietary rights. Any litigation, whether or not it is resolved in our favor, could result in significant expense to us and divert the efforts of our technical and management personnel.

We are dependent on our management team, and the loss of any key member of this team may prevent us from implementing our business plan in a timely manner.

Our success depends largely upon the continued services of our executive officers, particularly Dr. Paul Berger, our Chief Executive Officer and Chairman of the Board. The loss of Dr. Berger, Christopher R. Huber, our Chief Financial Officer, Jon D. Berger, our Vice President of Business Development, or Tim Mayleben, our Executive Vice President and Chief Operating Officer could have a material adverse effect on our business, financial condition, results of operations and the trading price of our common stock. Each of these named executives is employed on an at-will basis. In addition, the search for replacements could be time consuming and could distract our management team from the day-to-day operations of our business.

If we fail to implement and maintain an effective system of internal controls, we may not be able to report our financial results in an accurate or timely manner, prevent fraud or comply with Section 404 of the Sarbanes-Oxley Act of 2002, which may harm our business and affect the trading price of our stock.

Effective internal controls are necessary for us to provide reliable financial reports in a timely manner and to prevent fraud. Historically, we have had limited accounting personnel and other resources with which to design and implement our internal controls and procedures. As a result, in their audit of our fiscal 2004 financial statements, our auditors identified in their report to our audit committee material weaknesses relating to the

Table of Contents

adequacy and competency of our financial reporting personnel. Following receipt of our auditor's report, we consulted with our audit committee and undertook remedial steps to address these deficiencies, including hiring additional staff and training our new and existing staff. Although our auditors did not identify material weaknesses in our internal controls in connection with their audit of our financial statements as of and for the year ended December 31, 2006 or 2005, we cannot assure you that we will maintain an effective system of internal controls in the future. Beginning with our annual report on Form 10-K for our fiscal year ending December 31, 2007, we will be required to comply with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 to include in each of our annual reports an assessment by our management of the effectiveness of our internal controls over financial reporting and a report of our independent registered public accounting firm addressing these assessments. If we fail to adequately staff and train our accounting and finance personnel to meet the demands of operating as a public company, including the requirements of the Sarbanes-Oxley Act of 2002, or fail to maintain adequate internal controls, any resulting material weakness in internal controls could prevent our management from concluding the internal controls are effective and impair our ability to prevent material misstatements in our financial statements, which could cause our business to suffer. In addition, investors' perceptions that our internal controls are inadequate or that we are unable to produce accurate financial statements in a timely manner or prevent fraud may negatively affect the trading price of our stock or result in stockholder litigation.

We may be unable to enforce non-compete agreements with our affiliated radiologists.

Our independent contractor agreements with our affiliated radiologists typically provide that the radiologists may not compete with us for a period of time, typically one year, after the agreements terminate. These covenants not to compete are enforceable to varying degrees from jurisdiction to jurisdiction. In most jurisdictions, a covenant not to compete will be enforced only to the extent that it is necessary to protect the legitimate business interest of the party seeking enforcement, that it does not unreasonably restrain the party against whom enforcement is sought and that it is not contrary to the public interest. This determination is made based upon all the facts and circumstances of the specific case at the time enforcement is sought. It is unclear whether our interests will be viewed by courts as the type of protected business interest that would permit us to enforce a non-competition covenant against the radiologists. A determination that these provisions are not enforceable could have a material adverse effect on us.

Enforcement of state and federal anti-kickback laws may adversely affect our business, financial condition or operations.

Various federal and state laws govern financial arrangements among healthcare providers. The federal anti-kickback law prohibits the knowing and willful offer, payment, solicitation or receipt of any form of remuneration in return for, or with the purpose to induce, the referral of Medicare, Medicaid, or other federal healthcare program patients, or in return for, or with the purpose to induce, the purchase, lease or order of items or services that are covered by Medicare, Medicaid, or other federal healthcare programs. Similarly, many state laws prohibit the solicitation, payment or receipt of remuneration in return for, or to induce the referral of patients in private as well as government programs. Violation of these anti-kickback laws may result in substantial civil or criminal penalties for individuals or entities and/or exclusion from participating in federal or state healthcare programs. If we are excluded from federal or state healthcare programs, our customers who participate in those programs would not be permitted to continue doing business with us. We believe that we are operating in compliance with applicable law and believe that our arrangements with providers would not be found to violate the anti-kickback laws. However, these laws could be interpreted in a manner inconsistent with our operations.

Table of Contents

Because our customers submit claims to the Medicare program based on the services we provide, it is possible that a lawsuit could be brought against us or our customers under the federal False Claims Act, and the outcome of any such lawsuit could have a material adverse effect on our business, financial condition and operations.

The Federal False Claims Act provides, in part, that the federal government may bring a lawsuit against any person whom it believes has knowingly presented, or caused to be presented, a false or fraudulent request for payment from the federal government, or who has made a false statement or used a false record to get a claim approved. The government has taken the position that claims presented in violation of the federal anti-kickback law may be considered a violation of the Federal False Claims Act. The Federal False Claims Act further provides that a lawsuit brought under that act may be initiated in the name of the United States by an individual who was the original source of the allegations, known as the relator. Actions brought under the Federal False Claims Act are sealed by the court at the time of filing. The only parties privy to the information contained in the complaint are the relator, the federal government and the court. Therefore, it is possible that lawsuits have been filed against us that we are unaware of or which we have been ordered by the court not to discuss until the court lifts the seal from the case. Penalties include fines ranging from \$5,500 to \$11,000 for each false claim, plus three times the amount of damages that the federal government sustained because of the act of that person. We believe that we are operating in compliance with the Medicare rules and regulations, and thus, the Federal False Claims Act. However, if we were found to have violated certain rules and regulations and, as a result, submitted or caused our customers to submit allegedly false claims, any sanctions imposed under the Federal False Claims Act could result in substantial fines and penalties or exclusion from participation in federal and state healthcare programs which could have a material adverse effect on our business and financial condition.

Federal regulatory and law enforcement authorities have recently increased enforcement activities with respect to Medicare and Medicaid fraud and abuse regulations and other reimbursement laws and regulations, including laws and regulations that govern our activities and the activities of teleradiologists. These increased enforcement activities may have a direct or indirect adverse affect on our business, financial condition and results of operations.

Additionally, some state statutes contain prohibitions similar to and possibly even more restrictive than the Federal False Claims Act. These state laws may also empower state administrators to adopt regulations restricting financial relationships or payment arrangements involving healthcare providers under which a person benefits financially by referring a patient to another person. We believe that we are operating in compliance with these laws. However, if we are found to have violated such laws, our business, results of operations and financial condition would be harmed.

Changes in the governmental interpretation or enforcement of the federal prohibition on physician self-referral may adversely affect our business, financial conditions or operations.

The federal Stark Law prohibits a physician from referring Medicare or Medicaid patients for the provision of designated health services by an entity in which the physician has an investment interest or with which the physician has entered into a compensation arrangement. Designated health services include both the professional and technical components of diagnostic tests using X-rays, ultrasound or other imaging services, CT, MRI, radiation therapy and diagnostic mammography services. Violation of the Stark Law may result in substantial civil penalties and/or exclusion from participation in federal health care programs for both the referring physicians and any entities that submit technical and/or professional component claims for any diagnostic tests ordered by those referring physicians. We believe that we have structured our arrangements between our affiliated radiologists and our customers in a manner that complies with applicable law. However, this law could be interpreted in a manner inconsistent with our arrangements.

Table of Contents

The trading price of our common stock has been volatile and will likely remain volatile.

The trading prices of many newly publicly-traded companies are highly volatile, particularly companies such as ours that have limited operating histories. Since our initial public offering in February 2006, the trading price of our common stock has been subject to wide fluctuations. Factors that will continue to affect the trading price of our common stock include:

variations in our operating results,

announcements of new services, strategic alliances or significant agreements by us or by our competitors,

recruitment or departure of key personnel,

changes in the estimates of our operating results or changes in recommendations by any securities analysts that follow our common stock, and

market conditions in our industry, the industries of our customers and the economy as a whole.

In addition, if the market for healthcare stocks or healthcare services or the stock market in general experiences loss of investor confidence, the trading price of our common stock could decline for reasons unrelated to our business, operating results or financial condition. The trading price of our common stock might also decline in reaction to events that affect other companies in our industry even if these events do not directly affect us.

If securities analysts do not publish research or reports about our business, or if they downgrade our stock, the price of our stock could decline.

The trading market for our common stock will rely in part on the availability of research and reports that third-party industry or financial analysts publish about us. There are many large, publicly-traded companies active in the healthcare services industry, which may mean it will be less likely that we receive widespread analyst coverage. Furthermore, if one or more of the analysts who do cover us downgrade our stock, our stock price would likely decline. If one or more of these analysts cease coverage of our company, we could lose visibility in the market, which in turn could cause our stock price to decline.

The concentration of our capital stock ownership with insiders will likely limit your ability to influence corporate matters.

Our executive officers, directors, current five percent or greater stockholders and affiliated entities collectively own a relatively large percentage of the outstanding shares of our common stock. As a result, these stockholders, acting together, will have control over most matters that require approval by our stockholders, including the election of directors and approval of significant corporate transactions. Corporate action might be taken even if other stockholders oppose them. This concentration of ownership might also have the effect of delaying or preventing a change of control of our company that other stockholders may view as beneficial.

We are exposed to foreign currency exchange risks, which could harm our business and operating results.

We maintain significant operations in Australia and Switzerland, and are exposed to adverse changes in exchange rates associated with the expenses of our operations in these countries. However, we do not currently engage in any hedging transactions to mitigate these risks. Although from time to time we review our foreign currency exposure and evaluate whether we should enter into hedging transactions, we may not adequately hedge against any future volatility in currency exchange rates and, if we engage in hedging transactions, the transactions will be based on forecasts which later may prove to be inaccurate. Any failure to hedge successfully or anticipate currency risks properly could adversely affect our operating results.

Table of Contents

In addition, most of our affiliated radiologists live in Australia and Switzerland, but receive compensation from us in U.S. dollars. Any relative weakness in the U.S. dollar compared to the Australian dollar or Swiss franc may increase the cost of living for our affiliated radiologists and make it less attractive for our affiliated radiologists to sign or renew their service contracts with us.

Provisions in our certificate of incorporation and bylaws and Delaware law might discourage, delay or prevent a change of control of our company or changes in our management and, therefore, depress the trading price of our common stock.

Our certificate of incorporation and bylaws contain provisions that could depress the trading price of our common stock by acting to discourage, delay or prevent a change in control of our company or changes in our management that the stockholders of our company may deem advantageous. These provisions:

establish a classified board of directors so that not all members of our board are elected at one time,

provide that directors may only be removed for cause,

authorize the issuance of blank check preferred stock that our board could issue to increase the number of outstanding shares and to discourage a takeover attempt,

eliminate the ability of our stockholders to call special meetings of stockholders,

prohibit stockholder action by written consent, which has the effect of requiring all stockholder actions to be taken at a meeting of stockholders,

provide that the board of directors is expressly authorized to make, alter or repeal our bylaws, and

establish advance notice requirements for nominations for election to our board or for proposing matters that can be acted upon by stockholders at stockholder meetings.

In addition, Section 203 of the Delaware General Corporation Law may discourage, delay or prevent a change in control of our company.

If our security measures are breached and unauthorized access is obtained to patient or customer data, we may face liabilities and our system may be perceived as not being secure, causing customers to curtail or stop using our services, which could lead to a decline in revenues.

We are required to implement administrative, physical and technological safeguards to ensure the security of the patient data that we create, process or store. These safeguards may fail to ensure the security of patient or customer data, thereby subjecting us to liability, including civil monetary penalties and possible criminal penalties. If our security measures are breached, whether as a result of third party action, employee error, malfeasance or otherwise, and, as a result, someone obtains unauthorized access to patient or customer data, our reputation will be damaged, our business may suffer and we could incur significant liability. Because techniques used to obtain unauthorized access to systems change frequently and generally are not recognized until launched against a target, we may be unable to anticipate these techniques or to implement adequate preventive measures.

ITEM 1B. Unresolved Staff Comments

None.

Table of Contents**ITEM 2. Properties**

The table below provides a summary of the Company's principal facilities as of December 31, 2006:

| Location | Total Square Feet (1) | Leased or Owned | Principal Function |
|----------------------|------------------------------|------------------------|---|
| Coeur d'Alene, Idaho | 15,000 | Leased | Headquarters and Administration |
| Sydney, Australia | 9,000 | Leased | Reading facility and support staff operations |
| Zurich, Switzerland | 8,000 | Leased | Reading facility and support staff operations |
| Austin, Texas | 5,000 | Leased | Reading facility |
| Milwaukee, Wisconsin | 3,000 | Leased | Information Technology center |

(1) Rounded to the nearest thousand square feet.

ITEM 3. Legal Proceedings

We are involved in various legal proceedings arising in the ordinary course of our business activities. We maintain insurance policies with coverages that we believe are appropriate in light of the risks attendant to our business, and believe that the resolution of the current claims will not have a material adverse impact on our consolidated results of operations, cash flows or our financial position. However, depending on the amount of damages resulting from a current or future claim, an unfavorable resolution of a claim could materially affect our future results of operations, cash flows or financial position.

ITEM 4. Submission of Matters to a Vote of Security Holders

None.

Table of Contents**PART II****ITEM 5. Market for Registrant's Common Stock, Related Stockholder Matters and Issuer Purchases of Equity Securities**
Market for Our Common Stock

Our common stock has been traded on the NASDAQ under the symbol NHWK since February 9, 2006, the date of our initial public offering. Prior to that time, there was no public market for our common stock. The following table sets forth, for the period indicated, the high and low sales prices of our common stock, reported by the Nasdaq National Market from February 2006 through June 2006, and by the Nasdaq Global Market from July 2006 forward.

| Fiscal Year Ended December 31, 2006 | Common Stock Price | |
|--|---------------------------|------------|
| | High | Low |
| First Quarter (from February 9) | \$ 27.50 | \$ 18.01 |
| Second Quarter | \$ 24.95 | \$ 15.75 |
| Third Quarter | \$ 20.75 | \$ 15.60 |
| Fourth Quarter | \$ 28.00 | \$ 16.85 |

 Holders

On February 16, 2007, the last reported sale price for our common stock on the Nasdaq Global Market was \$22.55 per share. As of February 16, 2007, there were approximately 45 holders of record of our common stock, although there are a much larger number of beneficial owners.

 Dividends

In September 2005, we distributed \$13.0 million as a special distribution to the holders of our common stock and redeemable preferred stock. Immediately prior to our initial public offering in February 2006, we distributed an additional \$7.0 million as another special distribution to the holders of our common stock and redeemable preferred stock.

Except for the special distributions noted above, we have never declared or paid any cash dividend on our capital stock. We currently intend to retain future earnings and do not expect to pay any dividends in the foreseeable future.

 Securities Authorized for Issuance Under Equity Compensation Plans

Please see Part III, Item 12 of this report for disclosure relating to our equity compensation plans.

Table of Contents**Performance Graph**

The performance graph below illustrates a ten month comparison of cumulative total stockholder return data based on an initial investment of \$100 in NightHawk Radiology Holdings, Inc. common stock, as compared with the Russell 2000 Index and the Dow Jones US Healthcare Index for February 9, 2006 through December 31, 2006.

| | 2/9/06 | 3/31/06 | 6/30/06 | 9/30/06 | 12/31/06 |
|-------------------------|---------------|----------------|----------------|----------------|-----------------|
| NightHawk Radiology | \$ 100 | \$ 115.69 | \$ 86.88 | \$ 92.64 | \$ 123.49 |
| Russell 2000 | \$ 100 | \$ 106.75 | \$ 100.95 | \$ 101.65 | \$ 110.17 |
| Dow Jones US Healthcare | \$ 100 | \$ 100.30 | \$ 95.35 | \$ 103.34 | \$ 104.61 |

Recent Sales of Unregistered Securities

There were no unregistered sales of equity securities during fiscal 2006.

Issuer Purchases of Equity Securities

There were no issuer purchases of equity securities during fiscal 2006.

Table of Contents**ITEM 6. Selected Consolidated Financial Data**

The following selected consolidated financial data should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements included elsewhere in this report. The consolidated statements of operations data for the fiscal years ended December 31, 2004, 2005 and 2006 and the consolidated balance sheet data as of December 31, 2005 and 2006 were derived from our audited consolidated financial statements included elsewhere in this report. The consolidated statement of operations for the fiscal years ended December 31, 2002 and 2003 and the consolidated balance sheet data as of December 31, 2002, 2003 and 2004 was derived from our audited consolidated financial statements not included in this report. The historical results presented below are not necessarily indicative of financial results to be achieved in future periods.

| | For the Years Ended December 31, | | | | |
|---|----------------------------------|-----------------|---------------|---------------|--------------|
| | 2006 | 2005 | 2004 | 2003 | 2002 |
| Consolidated Statements of Operations data: | | | | | |
| Service revenue | \$ 92,168,246 | \$ 64,061,528 | \$ 39,283,002 | \$ 16,216,322 | \$ 4,666,645 |
| Operating costs and expenses (1): | | | | | |
| Professional services | 38,963,287 | 22,401,184 | 15,049,399 | 6,417,803 | 1,941,452 |
| Sales, general and administrative | 27,607,317 | 22,988,027 | 11,991,386 | 4,862,452 | 1,624,654 |
| Depreciation and amortization | 2,198,714 | 1,350,536 | 528,126 | 175,780 | 59,063 |
| Total operating costs and expenses | 68,769,318 | 46,739,747 | 27,568,911 | 11,456,035 | 3,625,169 |
| Operating income | 23,398,928 | 17,321,781 | 11,714,091 | 4,760,287 | 1,041,476 |
| Other income (expense): | | | | | |
| Interest expense | (562,221) | (1,178,323) | (880,671) | (6,915) | (40,072) |
| Interest income | 3,027,917 | 67,072 | 40,835 | 3,927 | |
| Other, net | (34,258) | (51,147) | (28,953) | 28,266 | (3,001) |
| Change in fair value of redeemable preferred stock conversion feature | (44,183,770) | (39,728,473) | (3,857,500) | | |
| Total other income (expense) | (41,752,332) | (40,890,871) | (4,726,289) | 25,278 | (43,073) |
| Income (loss) before income taxes | (18,353,404) | (23,569,090) | 6,987,802 | 4,785,565 | 998,403 |
| Income tax expense | 10,047,713 | 6,391,302 | 3,662,563 | | |
| Net income (loss) | (28,401,117) | (29,960,392) | 3,325,239 | 4,785,565 | 998,403 |
| Redeemable preferred stock accretion | (117,534) | (1,062,451) | (764,742) | | |
| Preferred dividends | | (5,486,555) | | | |
| Net income (loss) applicable to common stockholders | \$ (28,518,651) | \$ (36,509,398) | \$ 2,560,497 | \$ 4,785,565 | \$ 998,403 |
| Earnings (loss) per common share: | | | | | |
| Basic | \$ (1.00) | \$ (2.11) | \$.11 | \$.10 | \$.02 |
| Diluted | \$ (1.00) | \$ (2.11) | \$.11 | \$.10 | \$.02 |
| Weighted averages of common shares outstanding (2): | | | | | |
| Basic | 28,528,079 | 17,273,970 | 24,196,437 | 49,732,156 | 49,732,156 |
| Diluted | 28,528,079 | 17,273,970 | 24,196,437 | 49,732,156 | 49,732,156 |

Table of Contents

| | As of December 31, | | | | |
|---|--------------------|---------------|--------------|--------------|-----------|
| | 2006 | 2005 | 2004 | 2003 | 2002 |
| Consolidated Balance Sheet data: | | | | | |
| Cash and cash equivalents | \$ 46,500,818 | \$ 12,610,487 | \$ 5,813,861 | \$ 2,184,120 | \$ 53,269 |
| Working capital (3) | 88,023,262 | 3,756,024 | 4,165,078 | 4,350,332 | 267,248 |
| Total current assets | 99,459,894 | 25,280,023 | 12,226,876 | 5,267,631 | 999,005 |
| Total assets | 116,066,366 | 35,535,762 | 17,262,330 | 1,283,798 | 428,267 |
| Total long-term debt (including current portion) | | 24,003,429 | 12,000,000 | | |
| Total liabilities | 13,436,632 | 85,183,990 | 23,468,421 | 917,299 | 731,757 |
| Total stockholders' equity (deficit) | 102,629,734 | (78,161,397) | (22,708,950) | 5,634,130 | 695,515 |
| Dividend information: | | | | | |
| Cash dividends paid per common and preferred share | \$ 0.295 | \$ 0.549 | | | |
| Cash dividends declared but not yet paid per common and preferred share | | \$ 0.295 | | | |

- (1) Includes the non-cash stock-based compensation charges set forth in the following table (which amounts include a non-recurring, non-cash professional services charge of approximately \$1.5 million in 2004 associated with the issuance of shares of our common stock to one of our affiliated radiologists and a non-recurring, non-cash sales, general and administrative charge of approximately \$2.9 million in 2005 associated with the full acceleration of shares of common stock held by a former member of our board of directors).

| | Year Ended December 31, | | | | |
|--|-------------------------|------------|--------------|------------|------------|
| | 2006 | 2005 | 2004 | 2003 | 2002 |
| Professional services | | | | | |
| Non-cash stock-based compensation | \$ 4,886,678 | \$ 916,170 | \$ 1,544,781 | \$ 653,050 | \$ 262,765 |
| Sales, general and administrative | | | | | |
| Non-cash stock-based compensation | 1,073,455 | 3,273,018 | 144,822 | | |

- (2) The weighted average shares of common stock outstanding for the years ended December 31, 2004, 2003 and 2002, are based on the assumed conversion of LLC units into common stock at the beginning of 2001 based on the conversion ratio from the recapitalization transaction.
- (3) Defined as current assets minus current liabilities.

Table of Contents

ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis should be read in conjunction with our audited consolidated financial statements and notes thereto that appear elsewhere in this report. This discussion contains forward-looking statements reflecting our current expectations that involve risks and uncertainties. Actual results may differ materially from those discussed in these forward-looking statements due to a number of factors, including those set forth in the section entitled "Risk Factors" and elsewhere in this report.

Overview

We believe that we are the leading provider of radiology services to radiology groups and hospitals across the United States. Our team of American Board of Radiology-certified, U.S. state-licensed and hospital-privileged radiologists uses our proprietary workflow technology to provide radiological interpretations to our customers primarily from centralized reading facilities located in Sydney, Australia, Zurich, Switzerland and the United States.

Nighthawk Radiology Services, LLC, an Idaho limited liability company, was founded in August 2001 and began providing off-hours emergency radiology services in October 2001. On March 31, 2004, our management team, along with entities affiliated with Summit Partners, consummated a series of related transactions that resulted in the creation and capitalization of NightHawk Radiology Holdings, Inc., a Delaware corporation, and its acquisition of all the outstanding membership units of Nighthawk Radiology Services, LLC. These transactions resulted in Nighthawk Radiology Services, LLC becoming a wholly-owned subsidiary of NightHawk Radiology Holdings, Inc. NightHawk Radiology Holdings, Inc. conducts its operations primarily through Nighthawk Radiology Services, LLC.

On February 8, 2006, a registration statement relating to our initial public offering of our common stock was declared effective by the Securities and Exchange Commission. Under this registration statement, we registered the issuance of 5,800,000 shares of our common stock, and another 1,445,000 shares of our common stock sold by certain selling stockholders. All 7,245,000 shares of common stock issued pursuant to the registration statement, including the 1,445,000 shares sold by the selling stockholders, were sold at a price to the public of \$16.00 per share.

Executive Summary and Highlights

Acquisition of Teleradiology Diagnostic Service, Inc.

On February 9, 2007, we acquired Teleradiology Diagnostic Service, Inc., or TDS. We regard the acquisition of TDS as a strategic acquisition of an off-hours teleradiology business that is supplemental to our current business and that expands our presence in California. We purchased TDS for an aggregate price of \$23 million dollars, which was paid in cash at the closing of the acquisition.

Acquisition of American Teleradiology NightHawks, Inc.

On September 30, 2005, we acquired American Teleradiology Nighthawks, Inc., or ATN. We regard the ATN acquisition as an acquisition of an off-hours teleradiology business that is supplemental to our current business, and an early-stage teleradiology business that will continue to focus on partnering with radiologists in order to supplement the services they provide to their hospitals. The consideration to the ATN stockholders in connection with the acquisition was based primarily upon the future financial performance of these two businesses. Specifically, the consideration to the stockholders of ATN consists of:

315,279 shares of our common stock issued on September 30, 2005,

\$3,511,025 was recorded as additional consideration in September 2006, to be issued as an estimated 183,000 shares of our common stock to stockholders of ATN as of the acquisition date. The additional

Table of Contents

consideration was calculated in accordance with the provisions of the purchase agreement as the amount equal to (a) the quotient obtained by dividing (i) revenue generated by the off-hours teleradiology business from ATN customers during the twelve month period ended September 30, 2006 by (ii) \$12.69 (which was the value per share of Company common stock on the date of completion of the acquisition (as agreed by the parties)) minus (b) 315,279 (which was the number of shares of Company common stock issued to the stockholders of ATN at the completion of the acquisition). The contingent consideration ultimately due is subject to agreement by the former stockholders and Company management.

additional shares of Company common stock that may be issued in an amount equal to the sum of (a) the quotient obtained by dividing (i) earnings before interest, taxes, depreciation and amortization, or EBITDA, generated by the hospital business during the twelve month period ending March 31, 2007 by (ii) \$12.69, which was the value per share of Company common stock on the date of completion of the acquisition (as agreed by the parties), plus (b) the quotient obtained by dividing (A) three times (3x) the EBITDA amount described in clause (i) by (B) the fair market value of Company common stock, determined on a per share basis, on March 31, 2007.

The 315,279 shares of common stock that were issued at the completion of the acquisition were recorded at par value as common stock with additional amounts up to fair value recorded as Additional Paid-In Capital. The shares that may be issued as a result of the future financial performance of ATN are considered contingent consideration and will be recorded in a similar manner upon resolution of the contingency.

Critical Accounting Policies

The discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America, or U.S. GAAP. The preparation of these financial statements in accordance with U.S. GAAP requires us to utilize accounting policies and make certain estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingencies as of the date of the financial statements and the reported amounts of revenue and expenses during a fiscal period. The SEC considers an accounting policy to be critical if it is important to a company's financial condition and results of operations, and if it requires the exercise of significant judgment and the use of estimates on the part of management in its application. We have discussed the selection and development of the critical accounting policies with the audit committee of our board of directors, and the audit committee has reviewed our related disclosures in this report. Although we believe that our judgments and estimates are appropriate, actual results may differ from those estimates.

We believe the following to be our critical accounting policies because they are both important to the portrayal of our financial condition and results of operations and they require critical management judgment and estimates about matters that are uncertain:

revenue recognition and allowance for doubtful accounts,

stock-based compensation,

use of estimates,

accounting for redeemable preferred stock,

long-lived assets including goodwill and other acquired intangible assets, and

income taxes.

If actual results or events differ materially from those contemplated by us in making these estimates, our reported financial condition and results of operations for future periods could be materially affected. See Risk Factors for certain matters that may affect our future results of operations or financial condition.

Table of Contents

Revenue Recognition and Allowance for Doubtful Accounts

We enter into services contracts with our customers that typically have a one year term, and automatically renew for each successive year unless terminated by the customer or by us. The amount we charge for our radiology services varies by customer based on a number of factors, including the hours of coverage we provide for the customer, the number of reads we provide to the customer and the technical and administrative services we provide to the customer. We recognize revenue when we have satisfied all of our significant contractual obligations to our customers and we determine that the collection of the resulting receivable is reasonably assured. Revenue from services is recognized in the fiscal month in which the radiological interpretation is complete and forwarded to the customer. We review our historical collection experience on a quarterly basis to determine the necessity of a provision for doubtful accounts. As of December 31, 2006, we had reserved approximately \$0.4 million for doubtful accounts based on our estimate of the collectibility of outstanding receivables as of that date.

Stock-Based Compensation

Physician Stock-Based Compensation. The Company records share-based compensation expense in connection with any grant of stock options, restricted stock units, or other issuance of shares of common stock to our affiliated radiologists. We calculate the share-based compensation expense associated with the issuance of stock options to our affiliated radiologists in accordance with SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS No. 123 (R)) and Emerging Issues Task Force Issue No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services* (EITF No. 96-18), by determining the fair value using a Black-Scholes model. In accordance with EITF No. 96-18, because our radiologists are treated as independent contractors and not as employees, we calculate the fair value of the share-based compensation expense in each period. The expense amount is determined by calculating the fair value of the shares earned in each period and recording that amount as expense during such period. If the price of our common stock increases over a given period, this accounting treatment results in compensation expense that exceeds the expense we would have recorded if these individuals were employees. Stock-based compensation to our affiliated radiologists is included in professional services expense.

Non-Physician Stock-Based Compensation. We also record stock-based compensation expense in connection with any grant of stock options, restricted stock units, warrants or other issuance of shares of common stock to employees, directors and non-physician contractors. We calculate the stock-based compensation expense associated with the issuance of stock options and warrants to our employees, directors and non-physician contractors in accordance with SFAS No. 123 (R) by determining the fair value using a Black-Scholes model. We calculate the stock-based compensation expense related to the issuance of restricted stock units or shares of our common stock to our employees, directors and non-physician contractors based on the fair value of our common stock on the date the restricted stock units or shares are issued. Stock-based compensation to employees and non-physician contractors is included in sales, general and administrative expense.

Determination of Fair Value of our Stock Options. As indicated above, we record stock-based compensation expense associated with our stock options in accordance with SFAS No. 123 (R) and EITF No. 96-18, as applicable, which require us to calculate the expense associated with our stock options by determining the fair value of the options. To determine the fair value of our stock options, the Company uses a Black-Scholes model which takes into account the exercise price of the stock option, the fair value of the common stock underlying the stock option, as measured on the date of grant (or at each reporting date for grants to non-employees that require future service), and an estimation of the volatility of the common stock underlying the stock option.

Use of Estimates

On an ongoing basis, we evaluate our estimates relating to the items described below. We generally base our estimates on our historical experience (which is limited) and on various other assumptions that we believe to be reasonable along with the guidance provided by Statement of Financial Accounting Standard, or SFAS, No. 5, *Accounting for Contingencies*, the results of which form the basis for making judgments about the carrying values of assets and liabilities.

Table of Contents

Accounts receivable allowance. We monitor customer payments and maintain a reserve for estimated losses resulting from our customers inability to make required payments. In estimating the reserve, we evaluate the collectibility of our accounts receivable from a specific customer when we become aware of circumstances that may impair the customer's ability to meet its financial obligations and record an allowance against amounts due. To date, we have not experienced any material difficulties in collecting payments from our customers and only began maintaining a reserve for customer nonpayment during 2005. We believe that the potential aggregate amount of nonpayment by our customers is limited in part by the frequency of our billing cycle and the ease with which we may discontinue service to customers during periods of nonpayment. However, actual future losses from uncollectible accounts may differ from our estimates due to our limited experience in establishing reserves for nonpayment, our limited history of non-collection, and the difficulty in predicting the future payment practices of a large number of customers.

Fair value of redeemable preferred stock conversion feature. Prior to the date of our initial public offering, our estimates of the fair value of our redeemable preferred stock conversion feature were determined by management with the assistance of an independent valuation specialist. However, because our outstanding redeemable preferred stock converted into common stock at the closing of our initial public offering, we have not and will not record any additional charges associated with the change in fair value of the conversion feature after such date. As a result, since the closing of our initial public offering, we are no longer required to make these estimates.

Loss contingency for medical liability claims. We record a loss contingency for a medical liability claim in the month in which we deem such liability to be probable. Our determination of the probability of the liability is based upon a review of the claim by our executive staff, legal counsel and insurance carrier. Upon the determination that the liability is probable, we record a loss contingency for the claim up to the amount of the deductible specified in our medical liability insurance policy. To date, we have not experienced any liabilities for claims that were in excess of our prior loss contingency estimates for such claims. However, actual future losses from medical liability claims may differ from our estimates to the extent that we suffer an adverse determination for a claim that we did not deem the liability probable, did not record a loss contingency up to the maximum amount of our insurance deductible, or do not have insurance coverage.

Incurred But Not Reported Claims. The company uses actuarial assumptions to estimate and record a liability for incurred but not reported (IBNR) professional liability claims and engaged an external actuarial firm to assist in the calculation of these estimates. Our estimated IBNR liability is based on long-term industry trends and averages, and considers a number of factors, including changes in claim reporting patterns, claim settlement patterns, judicial decisions, and legislation and economic decisions. Our estimated IBNR liability will fluctuate if claims experience changes over time.

Accounting for Redeemable Preferred Stock

We account for derivative financial instruments in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. We record derivative financial instruments as assets or liabilities in our consolidated balance sheets, measured at fair value. We record the change in fair value of such instruments as non-cash gains or losses in our consolidated statements of operations. We do not enter into derivative contracts for trading purposes.

On March 31, 2004, in connection with the organization and capitalization of NightHawk Radiology Holdings, Inc., we issued 6,500,003 shares of redeemable preferred stock for a total consideration of \$13.0 million. Each share of redeemable preferred stock was convertible, at the option of the holder, into one share of common stock. The conversion feature of the redeemable preferred stock was considered an embedded derivative under the provisions of SFAS No. 133, and accordingly was accounted for separately from the redeemable preferred stock. We determined the fair value of the redeemable preferred stock conversion feature based upon the fair value of the underlying common stock. On the date of issuance, the estimated fair value of the conversion

Table of Contents

feature was approximately \$1.7 million which was recorded as a liability on the date of issuance, thus reducing the recorded value of the redeemable preferred stock to approximately \$11.3 million. At each balance sheet date, we adjusted the carrying value of the embedded derivative to estimated fair value and recognized the change in such estimated value in our consolidated statements of operations.

We also classified the redeemable preferred stock as mezzanine equity. As such, we accreted the carrying value of such stock to its redemption value using the effective interest method through the redemption period. In addition, the redeemable preferred stock accrued dividends since the date of issuance. We recognized these two types of accretion of redeemable preferred stock in our consolidated statement of operations as a decrease in net income available to common stockholders.

At the closing of our initial public offering, all outstanding shares of redeemable preferred stock converted into common stock. As a result, beginning at the closing of the initial public offering we have not recorded any additional charge associated with the change in fair value of the conversion feature. Effective February 9, 2006, the amount reported as fair value of the redeemable preferred stock conversion feature was reclassified to additional paid-in capital in the equity section of the balance sheet. Also, the rights of the holders of redeemable preferred stock to receive accrued dividends or to exercise redemption rights terminated. As a result, the accretion of redeemable preferred stock also terminated. These amounts were reclassified to stockholders' equity.

Long-Lived Assets Including Goodwill and Other Acquired Intangible Assets

The value of goodwill and intangible assets is stated at the lower of cost or fair value. Goodwill is not subject to amortization; however it is subject to periodic impairment assessments. Under the provisions of SFAS No. 142, *Goodwill and Other Intangible Assets*, we are required to perform at least annually an impairment test and to consider other indicators that may arise throughout the year to re-evaluate carrying value. Some factors we consider important, which could trigger an interim impairment review, include:

significant under-performance relative to historical or projected future operating results,

significant changes in the manner of our use of acquired assets or the strategy for our overall business, and

significant negative industry or economic trends.

If we determine through the impairment review process that goodwill or intangible assets have been impaired, we reduce goodwill and intangible assets by recording an impairment charge in our consolidated statement of operations in an amount equal to the amount that book value exceeds fair value at the date impairment is determined. We perform our annual impairment test in the last quarter of each fiscal year. SFAS No. 142 also requires that intangible assets with definite lives be amortized over their estimated useful lives. We amortize our acquired intangible assets with definite lives over periods ranging from seven months to ten years.

SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, requires impairment losses to be recognized for long-lived assets through operations when indicators of impairment exist and the underlying cash flows are not sufficient to support the asset's carrying value. In addition, SFAS No. 144 requires that a long-lived asset (disposal group) to be sold that meets certain recognition criteria be classified as held for sale and measured at the lower of carrying amount or fair value less cost to sell. SFAS No. 144 also requires that a long-lived asset subject to closure (abandonment) before the end of its previously estimated useful life continue to be classified as held and used until disposal, with depreciation estimates revised to reflect the use of the asset over its shortened useful life.

We regularly evaluate the carrying value of intangible and long-lived assets for events or changes in circumstances that indicate that the carrying amount may not be recoverable or that the remaining estimated useful life should be changed. Potential indicators of impairment can include, but are not limited to (1) history of operating losses or expected future losses, (2) significant adverse change in legal factors, (3) changes in the

Table of Contents

extent or manner in which the assets are used, (4) current expectations to dispose of the assets by sale or other means, and (5) reductions or expected reductions of cash flow. If we determine there is an indication of impairment, we compare undiscounted net cash flows to the carrying value of the respective asset. If the carrying value exceeds the undiscounted net cash flows, we perform an impairment calculation using discounted cash flows, valuation analyses from independent valuation specialists or comparisons to recent sales or purchase transactions to determine estimated fair value.

Income Taxes

As a limited liability company, or LLC, for all periods from inception through March 31, 2004, we were not subject to federal income taxes directly. Rather, the LLC members were subject to federal income taxation based on their respective allocation of the LLC's net taxable income or loss.

Since our recapitalization, we have recognized income taxes under the asset and liability method. This approach requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the carrying amounts and the tax bases of assets and liabilities.

Developing our provision for income taxes, including our effective tax rate and analysis of potential tax exposure items, if any, requires significant judgment and expertise in federal and state income tax laws, regulations and strategies, including the determination of deferred tax assets and liabilities and any estimated valuation allowances we deem necessary to value deferred tax assets. Our judgments and tax strategies are subject to audit by various taxing authorities. While we believe we have provided adequately for our income tax liabilities in our consolidated financial statements, adverse determinations by these taxing authorities could have a material adverse effect on our consolidated financial condition, results of operations or cash flows.

How We Generate Revenue

We generate substantially all of our revenue from the radiology services that we provide our customers. We typically provide these services pursuant to one-year services contracts that automatically renew for each successive year unless terminated by the customer or by us. The amount we charge for our radiology services varies by customer based upon a number of factors, including the hours of coverage we provide for the customer, the number of reads we provide to the customer and the technical and administrative services we provide to the customer.

We recognize revenue generated by our services during the month in which services are provided and we bill our customers at the beginning of the following month. Because the invoices are paid directly by our customers, we do not currently depend upon payment by third-party payors or patients.

Since our first full year of operations, we have experienced significant revenue growth, from \$4.7 million in 2002 to \$92.2 million in 2006. This growth in service revenue resulted primarily from:

an increase in our customer base,

an increase in utilization of our service by our customers,

an expansion of our service hours,

a high customer retention rate, and

our acquisition of ATN in September 2005 and DayHawk in November 2004.

As of December 31, 2006, our affiliated radiologists provided services to 551 customers serving 1,008 hospitals. The total number of hospitals we cover represents approximately 18% of all hospitals in the United States.

Table of Contents

Our Operating Expenses

Our operating expenses consist primarily of professional services expense, sales, general and administrative expense, interest expense and income tax expense. We record stock compensation expense in connection with equity issuances to our affiliated radiologists (which we refer to as physician stock-based compensation) and in connection with equity issuances to our employees, directors and non-physician contractors (which we refer to as non-physician stock-based compensation). In our consolidated statement of income, we present our physician stock-based compensation expense as part of our professional services expenses and our non-physician stock-based compensation as part of our sales, general and administrative expense.

Professional Services Expense. Our professional services expense consists primarily of the fees we pay to our affiliated radiologists for their services (which we refer to as professional service fees), physician stock-based compensation, the premiums we pay for medical liability insurance and medical liability loss contingency expense. Our affiliated radiologists are highly trained professionals and we compensate them accordingly. As a result, our professional service fees are our most significant expense. We structure our relationships with our affiliated radiologists such that they have control over the number of hours that they work. We pay our affiliated radiologists using a formula that is generally based upon the number of hours worked and the workload completed, and we also provide discretionary bonuses. We recognize professional service fee expense in the month in which the professional services are performed.

Malpractice Expense. We recognize expenses associated with medical liability premiums in the month in which the expense is incurred. The Company records reserves for both reported and incurred but not reported (IBNR) amounts. Reported amounts are reserved based upon the Company's best estimate of future probable costs. IBNR claims are estimated by a third party actuary using historical claims information received by our third party claims administrator and industry indices. This reserve is intended to cover potential medical claims that might arise related to the radiological interpretations performed by our affiliated radiologists.

Physician Stock-Based Compensation Expense. As described previously, we record physician stock-based compensation expense in connection with any stock options, restricted stock units or other issuance of shares of our common stock to our affiliated radiologists and present this expense in our consolidated statements of operations as part of our professional services expense. We calculate the stock-based compensation expense associated with the issuance of stock options and warrants to affiliated radiologists in accordance with SFAS No. 123(R) and EITF No. 96-18.

Sales, General and Administrative Expense. Sales, general and administrative expense consists primarily of salaries and related expenses for all employees and non-physician contractors, non-physician stock-based compensation, information technology and telecommunications expenses, costs associated with licensing and privileging our affiliated radiologists, facilities and office-related expenses, sales and marketing expenses and other general and administrative expenses.

Non-Physician Stock-Based Compensation Expense. As described previously, we record non-physician stock-based compensation expense in connection with any grant of stock options, restricted stock units, warrants or other issuance of shares of our common stock to our employees, directors and non-physician contractors and present this expense in our consolidated statement of income as part of our sales, general and administrative expense. We calculate the stock-based compensation expense associated with the issuance of stock options and warrants to our employees, directors and non-physician contractors in accordance with SFAS No. 123(R).

Our Non-Operating Expenses

In addition to our operating expenses, we record the following non-operating expenses.

Interest Expense. The interest expense we incur in a given period is directly attributable to the principal amount of debt we have outstanding during such period.

Table of Contents

Change in Fair Value of Redeemable Preferred Stock Conversion Feature. We entered into a stockholders agreement with the holders of our Series A preferred stock pursuant to which we agreed to repurchase all or any portion of the shares of redeemable preferred stock then held by such holders at any time after seven years from the date of issuance. The redemption provision in the stockholders agreement, which terminated upon the closing of our initial public offering, provided that the repurchase price for such shares of redeemable preferred stock would be the greater of (i) the market value of the common stock issuable upon conversion of the redeemable preferred stock or (ii) the liquidation value of such shares of redeemable preferred stock (including all accrued and unpaid dividends). The conversion feature of the redeemable preferred stock was considered an embedded derivative under the provisions of SFAS No. 133, and accordingly was accounted for separately from the redeemable preferred stock. On the date of issuance, the estimated fair value of the conversion feature was \$1.7 million which was recorded as a liability on the balance sheet date on the date of issue thus reducing the recorded value of the redeemable preferred stock to \$11.3 million. While these shares remained outstanding, on each balance sheet date subsequent to the execution of that agreement, we adjusted the carrying value of the embedded derivative to estimated fair value and recognized the change in such estimated value in our consolidated statements of operations.

At the closing of our initial public offering, all outstanding shares of redeemable preferred stock converted into shares of common stock, and, as a result, we have not recorded any additional expenses associated with the change in fair value of the conversion feature of our redeemable preferred stock after such date.

Income Tax Expense. We recognize income taxes under the asset and liability method. This approach requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the carrying amounts and the tax bases of assets and liabilities.

Redeemable Preferred Stock Accretion. Shares of our redeemable preferred stock accrued dividends from the date of issuance until their conversion into shares of common stock at the closing of our initial public offering. The redeemable preferred stock dividends were cumulative and accrued at a rate of 6% per annum based on the sum of the liquidation value of each share of redeemable preferred stock, \$2.00, plus all accumulated and unpaid dividends. Dividends accumulated at the end of each calendar quarter. In addition to accruing dividends, we also accrued the carrying amount of the redeemable preferred stock to its redemption value using the effective interest method through the redemption period. We recognized these two types of accretion of redeemable preferred stock in our consolidated statements of operations as a decrease in net income available to common stockholders.

At the closing of our initial public offering, all outstanding shares of redeemable preferred stock converted into shares of common stock and the rights of the holders of redeemable preferred stock to receive accrued dividends or to exercise redemption rights terminated. As a result, the accretion relating to our redeemable preferred stock also terminated. These amounts are now reported within stockholders' equity.

Trends in our Business and Results of Operations

Revenue Trends. Our business has grown rapidly since inception. This growth has been driven primarily by an increase in our customer base, an increase in utilization of our service by our customers, an expansion of our service hours, a high customer retention rate and the growth in the use of diagnostic imaging technologies and procedures in the healthcare market. Our strategy is to expand on our position as the leading provider of radiology services by:

expanding our radiology group customers' utilization of our services as they implement coverage of additional hospitals,

expanding our service offerings to include final and subspecialty interpretations and cardiac imaging services,

Table of Contents

targeting new customers,

marketing to our customers the additional available hours of coverage,

pursuing strategic acquisitions, and

developing markets for our data and technology solutions.

Our revenue has increased in absolute dollars each year since inception and our revenue growth rate has been strong. However, our revenue growth rate declined from 2005 to 2006 when compared with our growth rate from 2004 to 2005 and the rate of growth will likely continue to decline as a result of the increased revenue base against which future periods will be compared. We expect that a number of our customers will implement our new service offerings, continue to implement coverage for additional hospitals as well as continue to use additional hours of our service, resulting in an overall increase in the utilization of our service by those customers.

Historically, we have seen an increase in same-site volumes during the second and third quarters of each fiscal year, when weather conditions tend to be warmer in much of the United States. We believe these increases are a result of increased outdoor and transportation activities during summer months. During the first and fourth quarters of each fiscal year, when weather conditions are colder for a large portion of the United States, we have historically experienced relatively lower same-site volumes than those experienced during the second and third quarters. We expect this seasonality to continue.

Trends in Professional Service Fees. Since inception, our professional service fees have increased in absolute dollars each year, primarily due to the addition of new radiologists to perform an increased workload as our business has grown. We expect that our professional service fees will continue to increase in absolute dollars as we contract with additional radiologists to meet the increasing demand for our services, as we begin to offer additional services, and as a result of scheduled increases in hourly fees under our existing agreements with our affiliated radiologists.

Trends in Medical Liability Expense. Our medical liability expense has also increased in absolute dollars each year since inception, primarily due to increases in our medical liability premiums as our business has grown and our ability to forecast claim experience not yet reported has developed. We expect our medical liability premiums and our IBNR expense to continue to increase in future periods as our business grows. In addition, if we have claims in future periods for which we deem a liability to be probable, our medical liability expense may increase.

Trends in Physician Stock-Based Compensation Expense. The amount of physician stock-based compensation expense we record in a given period depends primarily on the number of shares subject to outstanding options held by our affiliated radiologists, the amount of hours worked, and the change in the value of our common stock in that period. Because of the accounting treatment required by EITF 96-18, if the value of our common stock increases over a given period, we will record a compensation expense that generally exceeds the expense we would have recorded if these individuals were employees because EITF 96-18 requires us to record the increase in the value of the option during such period as an expense. As a result, because of the relatively significant increase in value of our common stock during the first quarter of 2006 primarily as a result of our initial public offering, we recorded significant physician stock-based compensation expense in 2006 when compared to 2005. Our expense in future periods for physician stock-based compensation will be driven primarily by new equity-based grants we make to our affiliated radiologists, the rate at which those equity awards and the currently outstanding options are earned over such periods, as well as changes, if any, in our stock price during such periods.

Trends in Sales, General and Administrative Expense. Our sales, general and administrative expense has increased in absolute dollars each year since inception primarily as a result of increased payroll expenses in connection with the addition of key management personnel, software development professionals and the implementation of executive and employee bonuses. We expect that these payroll expenses will continue to

Table of Contents

increase as we continue to increase headcount at all levels as our business continues to grow. In addition to increased payroll expense, we expect that our general and administrative expense will increase in absolute dollars due to increases in telecommunications and information technology costs and licensing and privileging costs. Also, we expect that our general and administrative expense will increase in absolute dollars due to increases in facilities expenses related to our offices in San Francisco, California and Austin, Texas and increases in legal, accounting, consulting, staffing and insurance costs associated with being a public company. Accordingly, we expect sales, general and administrative expense to increase in absolute dollars in future periods.

Trends in Non-Physician Stock-Based Compensation Expense. In June 2005, our board of directors agreed to accelerate the vesting of the 638,876 shares of common stock held by one of our former directors which resulted in a non-physician stock-based compensation expense of approximately \$2.9 million, which contributed to a relatively significant non-physician stock-based compensation expense in 2005. Although our non-physician stock-based compensation expense was only 1% of revenue for 2006, as we continue to grant options and restricted stock units to our employees, directors and non-physician contractors, we expect our non-physician stock-based compensation expense to increase in future periods.

Trends in Interest Expense. For 2005 and first quarter of 2006 our interest expense was attributable to the principal amount of debt we had outstanding primarily as a result of a loan agreement with Comerica Bank. Pursuant to this loan agreement, we borrowed an aggregate of \$35.0 million at various times throughout 2005 and the first quarter of 2006. We used the proceeds from this loan facility in part to repay previously existing debt and in part to fund a special distribution of \$20.0 million to the holders of our then-outstanding common stock and redeemable preferred stock. We repaid all of this indebtedness on February 14, 2006 with a portion of the proceeds from our initial public offering.

Trends in Interest Income. In February 2006, we completed an initial public offering of our common stock from which we received net proceeds of \$84.2 million after deducting underwriter discounts and commissions and approximately \$2.1 million in offering costs. Of this amount, we invested approximately \$63.0 million in a mix of highly-liquid, investment-grade securities and cash, primarily consisting of securities issued by U.S. government and federal agencies along with money market accounts and municipal securities. We expect this amount to decrease in future periods as we utilize a portion of these securities to fund acquisitions and expansion of operations.

Trends and Treatment of Redeemable Preferred Stock. Upon the closing of our initial public offering, all outstanding shares of redeemable preferred stock converted into shares of common stock and the rights of the holders of redeemable preferred stock to receive accrued dividends or to exercise redemption rights terminated. As a result, since the date of the closing of our initial public offering, we have not recorded any additional expenses associated with the change in fair value of the conversion feature of our redeemable preferred stock, and the accretion relating to our redeemable preferred stock has terminated.

Table of Contents**Results of Operations**

The following table sets forth selected consolidated statements of operations data for each of the periods indicated as a percentage of service revenue.

| | Fiscal Year Ended December 31, | | |
|---|--------------------------------|-------|------|
| | 2006 | 2005 | 2004 |
| Service revenue | 100% | 100% | 100% |
| Operating costs and expenses: | | | |
| Professional services (1) | 43 | 35 | 38 |
| Sales, general and administrative (2) | 30 | 36 | 31 |
| Depreciation and amortization | 2 | 2 | 1 |
| Total operating costs and expenses | 75 | 73 | 70 |
| Operating income | 25 | 27 | 30 |
| Other income (expense): | | | |
| Interest expense | (1) | (2) | (2) |
| Interest income | 4 | | |
| Other, net | | | |
| Change in fair value of redeemable preferred stock conversion feature | (48) | (62) | (10) |
| Total other income (expense) | (45) | (64) | (12) |
| Income (loss) before income taxes | (20) | (37) | 18 |
| Income tax expense | 11 | 10 | 9 |
| Net income (loss) | (31) | (47) | 9 |
| Redeemable preferred stock accretion | | (2) | (2) |
| Preferred dividends | | (8) | |
| Net income (loss) applicable to common stockholders | (31)% | (57)% | 7% |

- (1) Includes non-cash stock-based compensation expense of \$4,886,678 for 2006, \$916,170 for 2005 and \$1,544,781 (which amount includes a non-recurring, non-cash professional services expense of approximately \$1.5 million associated with the issuance of shares of our common stock to one of our affiliated radiologists) for 2004.
- (2) Includes non-cash stock-based compensation expense of \$1,073,455 for 2006, \$3,273,018 (which amount includes a non-recurring, non-cash sales, general and administrative expense of approximately \$2.9 million associated with the full acceleration of shares of common stock held by a former member of our board of directors) for 2005 and \$144,822 for 2004.

Comparison of Fiscal Years Ended December 31, 2006 and December 31, 2005*Service Revenue*

| | Fiscal Year Ended December 31, | | Change | |
|-----------------|-----------------------------------|---------------|---------------|------------|
| | 2006 | 2005 | In Dollars | Percentage |
| Service revenue | \$ 92,168,246 | \$ 64,061,528 | \$ 28,106,718 | 44% |

The increase in service revenue from the year ended December 31, 2005 compared to the year ended December 31, 2006 resulted primarily from a 52% increase in volumes primarily due to an increase in the number of our radiology group customers and their affiliated hospitals, an increase in utilization by our customers of our hours of service and the growth in the use of diagnostic imaging technologies and procedures in the

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-K

healthcare market during this period. The number of radiology group and hospital customers to which we provided service increased from 463 as of December 31, 2005 to 551 as of December 31, 2006, a 19% increase in

Table of Contents

customers, and the number of hospital sites to which we provided service increased from 860 as of December 31, 2005 to 1,008 as of December 31, 2006, a 17% increase. The increase in the number of our customers and hospitals served resulted primarily from increased market acceptance of teleradiology as a solution, an increase in the recognition by the marketplace of the quality of our service offerings, the success by our sales professionals in generating new customers, and an improvement in our ability to meet the increased demand for our service, primarily through the addition of affiliated radiologists and the expansion of our hours of service.

*Operating Costs and Expenses**Professional Services*

| | Fiscal Year Ended | | Change | |
|-------------------------------|-------------------|---------------|---------------|------------|
| | December 31, | | In Dollars | Percentage |
| | 2006 | 2005 | | |
| Professional services (1) | \$ 38,963,287 | \$ 22,401,184 | \$ 16,562,103 | 74% |
| Percentage of service revenue | 43% | 35% | | |

(1) Includes non-cash stock-based compensation expense of \$4,886,678 for 2006 and \$916,170 for 2005.

The increase in professional services expense for the year ended December 31, 2006 compared to the year ended December 31, 2005 resulted primarily from an increase in the number of our affiliated radiologists providing service, an increase in our 2006 medical liability expense due to our IBNR reserve, an increase in our physician stock-based compensation expense, as well as an increase in the professional service fees we paid to our affiliated radiologists as a result of increased volumes and scheduled increases in hourly rates under the terms of the professional services agreements with our affiliated radiologists. From December 31, 2005 to December 31, 2006, we increased the number of our affiliated radiologists from 47 to 62. This increase was driven primarily by the increased demand for our services and was attributable to our ability to effectively recruit additional radiologists to meet such demand. While our professional services expense increased by 74% for the period, our professional services expense as a percentage of service revenue increased from 35% for the year ended December 31, 2005, to 43% for the year ended December 31, 2006 due to the expenses described below:

Professional Service Fees. Our professional service fees increased from \$20.5 million for the year ended December 31, 2005 to \$30.2 million for the same period in 2006, a 48% increase, and, as a percentage of service revenue, from 32% to 33% during that same period. The increase in expense was largely due to the increased volume of radiological interpretations performed by our affiliated radiologists due to the Company's continued growth. The slight increase as a percentage of revenue is driven by modest price declines in the current year.

Physician Stock-Based Compensation Expense. We experienced a significant increase in non-cash physician stock-based compensation expense from approximately \$0.9 million for the year ended December 31, 2005 to approximately \$4.9 million for 2006. As a percentage of service revenue, physician stock-based compensation expense increased from 1% for the year ended December 31, 2005 to 5% for the same period in 2006. This increase was driven primarily by a significant increase in our stock price which was primarily due to the completion of our initial public offering, an increased number of physicians, and increased vesting in options held by our physicians.

Medical Liability Expense. Our medical liability expense increased from approximately \$1.0 million for 2005 to approximately \$3.9 million for 2006. Of the expense recorded in 2006, approximately \$0.6 million was attributable to a claims loss contingency expense on reported medical liability claims and \$2.0 million was attributable to an IBNR reserve for exposure related to potential medical liability claims that have not yet been reported. This IBNR charge represents a transition to an actuarial-based analysis that the company has only recently been able to complete due to its limited operating and claims experience. The IBNR charge for 2006 is intended to cover potential medical claims that might arise related to all of the radiological interpretations performed by our affiliated radiologists since inception. We will continue to monitor the amount of this reserve and may adjust it from time to time as appropriate in light of our future volumes and claims experience.

Table of Contents*Sales, General and Administrative*

| | Fiscal Year Ended | | Change | |
|---------------------------------------|----------------------|----------------------|--------------|------------|
| | December 31, 2006 | December 31, 2005 | In Dollars | Percentage |
| Sales, general and administrative (1) | \$ 27,607,317 | \$ 22,988,027 | \$ 4,619,290 | 20% |
| Percentage of service revenue | 30% | 36% | | |

(1) Includes non-cash stock-based compensation expense of \$1,073,455 for 2006 and \$3,273,018 (which amount includes a non-recurring, non-cash sales, general and administrative expense of approximately \$2.9 million associated with the full acceleration of shares of common stock held by a former member of our board of directors) for 2005.

Total sales, general and administrative expenses are up 20% over 2005. The increase in sales, general and administrative expense was primarily due to increases in payroll expense due to additional hiring and costs associated with the continued growth in our business and increased costs associated with operating as a public company. Of the \$23.0 million of expense in the year ended December 31, 2005, approximately \$2.9 million was due to a non-cash stock compensation expense associated with a restricted stock grant to one of our former board members. Including non-cash stock compensation expense, expressed as a percentage of service revenue, sales, general and administrative expense is down from 36% for the year ended December 31, 2005 to 30% for the year ended December 31, 2006.

The following expenses comprise our sales, general and administrative expense:

Payroll and Related Expense. Our sales, general and administrative headcount increased from 172 at December 31, 2005 to 223 at December 31, 2006, a 30% increase, and resulted in an increase in payroll expense from \$11.8 million for 2005 to \$16.4 million for 2006, a 39% increase. This increase in payroll expense resulted primarily from personnel additions as a result of our continued growth. Expressed as a percentage of service revenue, our sales, general and administrative payroll and related expenses remained consistent at 18% of service revenue for both periods.

Information Technology and Telecommunications Expense. Our non-payroll information technology and telecommunications expense increased from approximately \$1.7 million for the year ended December 31, 2005 to approximately \$2.0 million for year ended December 31, 2006, an 18% increase. As a percentage of service revenue, IT and telecommunications expense decreased from 3% for 2005 to 2% for 2006. This decrease resulted primarily from lower telephone service costs as the Company implemented cost reduction initiatives.

Facilities Expense. Our facilities and office-based expense increased from approximately \$1.5 million for the year ended December 31, 2005 to \$2.0 million for the year ended December 31, 2006, a 31% increase. The increase in facilities and office-based expense was driven primarily by increased facilities and occupancy expenses associated with our facilities in Sydney, Australia, Zurich, Switzerland, Milwaukee, Wisconsin and Coeur d'Alene, Idaho.

Other General and Administrative Expense. Our other general and administrative expense consists primarily of professional accounting, legal and consulting services, general liability insurance and employee related expenses such as recruiting, travel and entertainment. Other general and administrative expense increased from approximately \$3.1 million for the year ended December 31, 2005 to approximately \$4.3 million for the year ended December 31, 2006, a 39% increase. The increase in other general and administrative expense was driven primarily by increased costs associated with operating as a public company such as investor relations and increased directors and officers' insurance policy premiums as well as costs associated with our secondary offering in October 2006, offset by lower accounting, recruiting and legal costs. In addition, we incurred higher travel and entertainment expenses as well as increased training and costs associated with the additional headcount.

Table of Contents

Non-Physician Stock-Based Compensation Expense. Our non-physician stock-based compensation expense decreased from approximately \$3.3 million for 2005 to approximately \$1.1 million for 2006. As a percentage of revenue, these costs were approximately 5% and 1% of revenue for the year ended December 31, 2005 and 2006, respectively. During 2005, approximately \$2.9 million of our non-physician stock-based compensation expense was related to the vesting of a restricted stock grant to one of our former board members.

Other Income (Expense)

Interest Expense

| | Fiscal Year Ended | | Change | |
|--------------------------------------|-------------------|--------------|--------------|------------|
| | December 31, | | In Dollars | Percentage |
| | 2006 | 2005 | | |
| Interest expense | \$ 562,221 | \$ 1,178,323 | \$ (616,102) | (52)% |
| <i>Percentage of service revenue</i> | <i>1%</i> | <i>2%</i> | | |

The interest expense for the year ended December 31, 2005 consisted primarily of interest payable under outstanding promissory notes issued to certain affiliates of Summit Partners and interest payable under a \$3.0 million revolving line of credit with Silicon Valley Bank. The aggregate principal balance of the outstanding promissory notes was approximately \$9.0 million through March 31, 2005. The aggregate principal balance of our revolving credit facility with Silicon Valley Bank was \$3.0 million through March 31, 2005. On April 20, 2005, we entered into a loan agreement with Comerica Bank that provided us a \$12.0 million term loan facility and a \$3.0 million revolving line of credit. We used the proceeds from the term loan facility to repay in full all outstanding indebtedness under the promissory notes held by the entities affiliated with Summit Partners and the revolving credit facility with Silicon Valley Bank. In September 2005, we borrowed an additional \$13.0 million under our term loan facility with Comerica Bank and distributed the full amount as a special distribution to the holders of our common stock and redeemable preferred stock. Prior to the initial public offering in February 2006, we borrowed an additional \$7.0 million under our term loan facility with Comerica Bank and distributed the full amount as a special distribution to the holders of our common stock and redeemable preferred stock. Thus, our interest expense for 2005 consisted primarily of interest payable under our credit facility with Comerica Bank up until the termination of that agreement in February 2006. Upon the initial public offering in first quarter of 2006, we repaid the balance of the term loan with Comerica Bank and terminated the loan facility. Additionally, in the year ended December 31, 2006 we incurred an expense of approximately \$326,000 related to unamortized deferred loan fees as a result of terminating our credit facilities with Comerica Bank.

Interest Income

| | Fiscal Year Ended | | Change | |
|--------------------------------------|-------------------|-----------|--------------|------------|
| | December 31, | | In Dollars | Percentage |
| | 2006 | 2005 | | |
| Interest income | \$ 3,027,917 | \$ 67,072 | \$ 2,960,843 | 4414% |
| <i>Percentage of service revenue</i> | <i>4%</i> | <i>%</i> | | |

Interest income for the year ended December 31, 2006 consisted primarily of interest income on cash balances and marketable securities purchased from the cash we received in connection with our initial public offering and operations. We received cash proceeds of \$86.3 million, of which approximately \$30.1 million was used to repay all outstanding indebtedness to Comerica Bank. We invested the remaining balance in a mix of highly-liquid, investment-grade securities and cash, primarily consisting of securities issued by U.S. government and federal agencies along with money market accounts and municipal securities.

Table of Contents*Change in Fair Value of Redeemable Preferred Stock Conversion Feature*

| | Fiscal Year Ended | | Change In Dollars | Change Percentage |
|---|----------------------|----------------------|----------------------|----------------------|
| | December 31, 2006 | December 31, 2005 | | |
| Change in fair value of redeemable preferred stock conversion feature | \$ 44,183,770 | \$ 39,728,473 | \$ 4,455,297 | 11% |
| <i>Percentage of service revenue</i> | <i>48%</i> | <i>62%</i> | | |

During the year ended December 31, 2005, the fair value of the redeemable preferred stock conversion feature increased by a total of \$39.7 million. In 2006 through the closing of our initial public offering, the fair value of the redeemable preferred stock conversion feature increased by a total of \$44.2 million, resulting in a non-cash expense of \$44.2 million in the first quarter of 2006. At the time of the closing of our initial public offering in the first quarter of 2006, all outstanding shares of redeemable preferred stock converted into common stock, and, as a result, after such date we have not recorded any additional expenses associated with the change in fair value of the conversion feature of our redeemable preferred stock.

Income Tax Expense

| | Fiscal Year Ended | | Change In Dollars | Change Percentage |
|--------------------------------------|----------------------|----------------------|----------------------|----------------------|
| | December 31, 2006 | December 31, 2005 | | |
| Income tax expense | \$ 10,047,713 | \$ 6,391,302 | \$ 3,656,411 | 57% |
| <i>Percentage of service revenue</i> | <i>11%</i> | <i>10%</i> | | |

We recorded an income tax expense of approximately \$10.0 million for 2006 and approximately \$6.4 million for 2005. The change in income tax expense is due to a corresponding change in net income, as compared to the same period for 2005. Our effective tax rate decreased from an effective rate of (27.1%) in 2005 to (54.7%) in 2006. The change in effective tax rate is due primarily to the change in the fair value of the redeemable preferred stock conversion feature, which is a permanent difference not deductible for tax purposes.

Preferred Stock Accretion

| | Fiscal Year Ended | | Change In Dollars | Change Percentage |
|--------------------------------------|----------------------|----------------------|----------------------|----------------------|
| | December 31, 2006 | December 31, 2005 | | |
| Preferred stock accretion | \$ 117,534 | \$ 1,062,451 | \$ (944,917) | (89)% |
| <i>Percentage of service revenue</i> | <i>%</i> | <i>2%</i> | | |

The preferred stock accretion is comprised of two types of accretion based on the underlying redeemable convertible preferred stock. For the year ended December 31, 2006, the preferred stock accretion consisted of approximately \$93,000 as a result of the accretion of dividends at a daily rate of 6% per annum, and approximately \$25,000 as a result of the amortization of the carrying amount of the redeemable convertible preferred to its redemption value using the effective interest method through the redemption period. For 2005, the preferred stock accretion consisted of approximately \$0.8 million as a result of the accretion of dividends and approximately \$0.2 million as a result of the amortization. At the time of the closing of our initial public offering in the first quarter of 2006, all outstanding shares of redeemable preferred stock converted into common stock and, as a result, after such date we did not record any additional accretion and amortization associated with the preferred stock. Thus, because we recorded an expense due to the accretion of our preferred stock for only a portion of the first quarter of 2006, we experienced lower expense than that recorded in 2005. We will no longer record this expense in future periods.

Table of Contents*Preferred Dividends*

| | Fiscal Year Ended | | Change | |
|--------------------------------------|----------------------|----------------------|----------------|------------|
| | December 31, 2006 | December 31, 2005 | In Dollars | Percentage |
| Preferred dividends | \$ | \$ 5,486,555 | \$ (5,486,555) | (100)% |
| <i>Percentage of service revenue</i> | % | 9% | | |

In September 2005, we borrowed \$13.0 million under our term loan facility with Comerica Bank and distributed the full amount as a special distribution to the holders of our common stock and redeemable preferred stock. A second dividend in the amount of \$7.0 million was also declared in September 2005 and was distributed as a special distribution to the holders of our common stock and redeemable preferred stock in February 2006. Approximately \$5.5 million of these combined amounts was attributable to the holders of our redeemable preferred stock.

Comparison of Fiscal Years Ended December 31, 2005 and December 31, 2004*Service Revenue*

| | Fiscal Year Ended | | Change | |
|-----------------|----------------------|----------------------|---------------|------------|
| | December 31, 2005 | December 31, 2004 | In Dollars | Percentage |
| Service revenue | \$ 64,061,528 | \$ 39,283,002 | \$ 24,778,526 | 63% |

The increase in service revenue from 2004 to 2005 resulted primarily from an increase in the number of our radiology group customers and their affiliated hospitals. The number of radiology group and hospital customers to which we provided service increased from 297 as of December 31, 2004 to 463 as of December 31, 2005, a 56% increase in customers. The increase in the number of our customers resulted primarily from increased market acceptance of teleradiology as a solution, an increase in the recognition by the marketplace of the quality of our service offerings, the success by our sales professionals in generating new customers, and an improvement in our ability to meet the increased demand for our service, primarily through the addition of affiliated radiologists and the expansion of our hours of service. In addition, our increase in service revenue during this period also resulted from an increased utilization by our customers of our hours of service and the growth in the use of diagnostic imaging technologies and procedures in the healthcare market during this period. (For example, as of December 31, 2004, we provided service from 8 p.m. to 8 a.m. for hospitals located in the Eastern Time zone. As of December 31, 2005, we had expanded our service offering to 5 p.m. to 8 a.m. local time for all time zones in the continental United States as well as 24-hours per day on weekends and holidays.) We were able to provide these additional hours of coverage in part due to our acquisition of DayHawk Radiology Services, LLC as well as the establishment of an additional reading facility in Zurich, Switzerland. The increase in service revenue was offset partially by pricing pressure resulting from increased competition.

*Operating Costs and Expenses**Professional Services*

| | Fiscal Year Ended | | Change | |
|--------------------------------------|----------------------|----------------------|--------------|------------|
| | December 31, 2005 | December 31, 2004 | In Dollars | Percentage |
| Professional services (1) | \$ 22,401,184 | \$ 15,409,399 | \$ 7,351,785 | 49% |
| <i>Percentage of service revenue</i> | 35% | 38% | | |

(1) Includes non-cash stock-based compensation expense of \$1,544,781 for 2004 and \$916,170 for 2005.

Table of Contents

The increase in professional services expense from 2004 to 2005 resulted primarily from an increase in the number of our affiliated radiologists providing service as well as an increase in the professional service fees we paid to our affiliated radiologists as a result of scheduled increases in hourly rates under the terms of the professional services agreements with our affiliated radiologists. From December 31, 2004 to December 31, 2005, we increased the number of our affiliated radiologists from 27 to 47. This increase was driven primarily by the increased demand for our services and was attributable to our ability to effectively recruit additional radiologists to meet such demand. While our professional services expense increased by 49% for the period, our professional services expense as a percentage of service revenue decreased from 38% for 2004, to 35% for 2005. The following expenses comprise our professional services expense:

Professional Service Fees. While our professional service fees increased from \$12.7 million for 2004 to \$20.5 million for 2005, a 61% increase, our professional service fees as a percentage of service revenue remained unchanged at 32% during that same period.

Medical Liability Expense. Our medical liability expense increased from approximately \$792,000 for 2004 to approximately \$1,009,000 for 2005, a 27% increase. Of the approximately \$792,000 expense recorded in 2004, \$200,000 was attributable to a claims loss contingency expense on two medical liability claims. We had no claims loss contingency expense for 2005.

Physician Stock-Based Compensation Expense. Physician stock-based compensation expense decreased from approximately \$1,545,000 for 2004 to approximately \$916,000 for 2005. The physician stock-based compensation expense recorded for 2004 resulted primarily from a warrant we had issued to one of our affiliated radiologists. In November 2004, we issued shares of our common stock in satisfaction of such warrant and, therefore, did not record any additional compensation expense related to that warrant after that time. In 2005, we recorded physician stock-based compensation expense only as a result of options granted to our affiliated radiologists. As a percentage of revenue, this expense decreased from 4% for 2004 to 1% for 2005.

*Sales, General and Administrative***Fiscal Year Ended**

| | December 31, | | Change | |
|---------------------------------------|---------------|---------------|---------------|------------|
| | 2005 | 2004 | In Dollars | Percentage |
| Sales, general and administrative (1) | \$ 22,988,027 | \$ 11,991,386 | \$ 10,996,641 | 92% |
| Percentage of service revenue | 36% | 31% | | |

- (1) Includes non-cash stock-based compensation expense of \$144,822 for 2004 and \$3,273,018 (which amount includes a non-recurring, non-cash sales, general and administrative expense of approximately \$2.9 million associated with the full acceleration of shares of common stock held by a former member of our board of directors) for 2005.

The increase in our sales, general and administrative expense from 2004 to 2005 resulted primarily from increases in payroll expense due to increases in non-physician stock compensation as described more fully below under Non-Physician Stock-Based Compensation Expense. Our sales, general and administrative expense for 2005 expressed as a percentage of service revenue would have been 31% had it not been for an expense of approximately \$2.9 million associated with the acceleration of vesting on shares of stock held by one of our former directors. In addition, sales, general and administrative expense increased due to the following factors:

Payroll and Related Expense. Our sales, general and administrative headcount increased from 98 at December 31, 2004 to 172 at December 31, 2005, a 76% increase, and resulted in an increase in payroll expense from \$7.1 million for 2004 to \$11.8 million for 2005, a 66% increase. This increase in payroll expense resulted primarily from personnel additions in our quality control, information technology, finance, and licensing and privileging departments. Expressed as a percentage of service revenue, our sales, general and administrative payroll and related expenses were approximately 18% of service revenue for both 2004 and 2005.

Table of Contents

Information Technology and Telecommunications Expense. Our non-payroll information technology and telecommunications expense increased from approximately \$904,000 for 2004 to approximately \$1.7 million for 2005, a 91% increase. This increase resulted primarily from continued investment in the redundancy and reliability of our network as well as increased costs associated with implementing and supporting an increased number of customer sites.

Facilities Expense. Our facilities and office-based expense increased from approximately \$948,000 for 2004 to \$1.5 million for 2005, a 62% increase. The increase in facilities and office-based expense was driven primarily by increased facilities occupancy expenses associated with office expansions in Sydney, Australia, Zurich, Switzerland, Milwaukee, Wisconsin and Coeur d'Alene, Idaho. In addition, the Company incurred a full year's worth of lease expense from the DayHawk acquisition and a full quarter's worth of lease expense from the ATN acquisition.

Licensing and Privileging Expense. Our non-payroll licensing and privileging expense consists primarily of fees paid in connection with the state medical licenses and hospital privileges we obtain on behalf of our affiliated radiologists. As a result of our efforts to obtain these medical licenses and staff privileges for our affiliated radiologists, we incur administrative expenses as well as fees payable to the states and hospitals. Each state typically requires a fee to be paid in connection with the issuance of a medical license as well as an additional annual fee that must be paid to maintain the medical license. In addition, many hospitals have annual fees associated with the granting of medical staff privileges. Non-payroll licensing and privileging expenses increased from approximately \$930,000 for 2004 to approximately \$1.0 million for 2005, a 9% increase.

Other General and Administrative Expense. Our other general and administrative expense consists primarily of professional accounting and legal expenses. Other general and administrative expense increased from approximately \$1.6 million for 2004 to approximately \$3.1 million for 2005, a 94% increase. The increase in other general and administrative expense was driven primarily by increased accounting, travel and entertainment, and recruiting costs associated with additional headcount.

Non-Physician Stock-Based Compensation Expense. Our non-physician stock-based compensation expense increased from approximately \$145,000 for 2004 to approximately \$3,273,000 for 2005. This increase resulted primarily from a non-physician stock-based compensation expense of approximately \$2.9 million associated with the acceleration of vesting on 638,876 shares of common stock held by one of our directors. In addition, during 2005, we granted options to purchase 489,800 shares of common stock to our employees.

Other Income (Expense)

Interest Expense

| | Fiscal Year Ended | | Change | |
|-------------------------------|-------------------|------------|------------|------------|
| | December 31, | | In Dollars | Percentage |
| | 2005 | 2004 | | |
| Interest expense | \$ 1,178,323 | \$ 880,671 | \$ 297,652 | 34% |
| Percentage of service revenue | 2% | 2% | | |

The interest expense for 2004 and for 2005 consisted primarily of interest payable under outstanding promissory notes issued to certain affiliates of Summit Partners and interest payable under a \$3 million revolving line of credit with Silicon Valley Bank. The aggregate principal balance of the outstanding promissory notes was approximately \$9 million through April 20, 2005. The aggregate principal balance of our revolving credit facility with Silicon Valley Bank was \$3 million through April 20, 2005. On April 20, 2005, we entered into a loan agreement with Comerica Bank that provided us a \$12 million term loan facility and a \$3 million revolving line of credit. We used the proceeds from the term loan facility to repay in full all outstanding indebtedness under the promissory notes held by entities affiliated with Summit Partners and the revolving credit facility with Silicon Valley Bank. On February 14, 2006, we repaid all of our existing indebtedness under our loan agreement with Comerica Bank.

Table of Contents*Change in Fair Value of Redeemable Preferred Stock Conversion Feature*

| | Fiscal Year Ended | | Change | |
|---|-------------------|--------------|---------------|------------|
| | December 31, | | In Dollars | Percentage |
| | 2005 | 2004 | | |
| Change in fair value of redeemable preferred stock conversion feature | \$ 39,728,473 | \$ 3,857,500 | \$ 35,870,973 | 930% |
| <i>Percentage of service revenue</i> | 62% | 10% | | |

We first issued shares of our redeemable preferred stock on March 31, 2004. The fair value of the redeemable preferred stock conversion feature was determined to be approximately \$1,670,277 on March 31, 2004 and was recorded as a liability at the date of issuance, reducing the recorded value of redeemable preferred stock. From March 31, 2004 to December 31, 2004, the fair value of the redeemable preferred stock conversion feature increased from \$1,670,277 at March 31, 2004 to \$5,527,777 at December 31, 2004, resulting in a non-cash expense of \$3,857,500 for 2004. In 2005, the fair value of the embedded conversion feature increased from \$5,527,777 at December 31, 2004 to \$45,256,250 at December 31, 2005, resulting in a non-cash expense of \$39,728,473. At the time of the closing of our initial public offering, all outstanding shares of redeemable preferred stock converted into common stock, and, as a result, after such date we have not recorded any additional expenses associated with the change in fair value of the conversion feature of our redeemable preferred stock.

Income Tax Expense

| | Fiscal Year Ended | | Change | |
|--------------------------------------|-------------------|--------------|--------------|------------|
| | December 31, | | In Dollars | Percentage |
| | 2005 | 2004 | | |
| Income tax expense | \$ 6,391,302 | \$ 3,662,563 | \$ 2,728,739 | 75% |
| <i>Percentage of service revenue</i> | 10% | 9% | | |

We recorded an income tax expense of approximately \$3.7 million for 2004 and approximately \$6.4 million for 2005. Because we operated as a limited liability company during the first quarter of 2004, we were subject to federal income taxes for only the period of April 1, 2004 to December 31, 2004, resulting in a lower income tax expense as compared to the same period for 2005.

Preferred Stock Accretion

| | Fiscal Year Ended | | Change | |
|--------------------------------------|-------------------|------------|------------|------------|
| | December 31, | | In Dollars | Percentage |
| | 2005 | 2004 | | |
| Preferred stock accretion | \$ 1,062,451 | \$ 764,742 | \$ 297,709 | 39% |
| <i>Percentage of service revenue</i> | 2% | 2% | | |

The preferred stock accretion is comprised of two types of accretion based on the underlying redeemable convertible preferred stock. For 2004, the preferred stock accretion consisted of \$596,570 as a result of the accretion of dividends at a daily rate of 6% per annum, and \$168,171 as a result of the amortization of the carrying amount of the redeemable convertible preferred to its redemption value using the effective interest method through the redemption period. For 2005, the preferred stock accretion consisted of \$834,333 as a result of the accretion of dividends at a daily rate of 6% per annum, and \$228,118 as a result of the amortization of the carrying amount of the redeemable convertible preferred to its redemption value using the effective interest method through the redemption period. At the time of the closing of our initial public offering, all outstanding shares of redeemable preferred stock converted into common stock, and, as a result, after such date have not recorded any additional accretion and amortization associated with the preferred stock.

Table of Contents*Preferred dividends*

| | Fiscal Year Ended | | Change | |
|--------------------------------------|----------------------|----------|--------------|------------|
| | December 31, 2005 | 2004 | In Dollars | Percentage |
| Preferred dividends | \$ 5,486,555 | \$ | \$ 5,486,555 | % |
| <i>Percentage of service revenue</i> | <i>9%</i> | <i>%</i> | | |

In September 2005, we borrowed \$13 million under our term loan facility with Comerica Bank and distributed the full amount as a special distribution to the holders of our common stock and redeemable preferred stock. Of this amount, approximately \$5.5 million was distributed to the holders of our redeemable preferred stock. Prior to the initial public offering in February 2006, we borrowed an additional \$7 million under our term loan facility with Comerica Bank and distributed the full amount as another special distribution to the holders of our common stock and redeemable preferred stock prior to the closing of the initial public offering. Of this amount, approximately \$3.0 million was distributed to the holders of our redeemable preferred stock.

Seasonality in Operating Results

Historically, we have seen an increase in same-site volumes during the second and third quarters of each fiscal year, when weather conditions tend to be warmer in much of the United States. We believe these increases are a result of increased outdoor and transportation activities during summer months. During the first and fourth quarters of each fiscal year, when weather conditions are colder for a large portion of the United States, we have historically experienced relatively lower same-site volumes than those experienced during the second and third quarters. We expect this seasonality to continue.

Quarterly Results of Operations

The following table presents a summary of our unaudited consolidated results of operations for the eight quarters ended December 31, 2006. The information for each of these quarters has been prepared on a basis consistent with our audited consolidated financial statements. You should read this information in conjunction with our consolidated financial statements and notes thereto included elsewhere in this report. The operating results for any quarter are not necessarily indicative of results for any future period.

| | March 31, 2005 | June 30, 2005 | September 30, 2005 | December 31, 2005 | March 31, 2006 | June 30, 2006 | September 30, 2006 | December 31, 2006 |
|--|--------------------------------------|------------------|-----------------------|----------------------|-------------------|------------------|-----------------------|----------------------|
| | (in thousands except per share data) | | | | | | | |
| Service revenue | \$ 13,112 | \$ 15,332 | \$ 17,144 | \$ 18,474 | \$ 20,039 | \$ 22,877 | \$ 25,159 | \$ 24,093 |
| Operating costs and expenses | 8,870 | 12,796 | 11,754 | 13,320 | 14,994 | 15,361 | 16,951 | 21,463 |
| Operating income | 4,242 | 2,536 | 5,390 | 5,154 | 5,045 | 7,516 | 8,208 | 2,630 |
| Income (loss) before income taxes | 2,608 | (7,680) | (11,621) | (6,877) | (39,326) | 8,251 | 9,063 | 3,659 |
| Net income (loss) | \$ 1,049 | \$ (8,585) | \$ (13,586) | \$ (8,838) | \$ (41,226) | \$ 5,036 | \$ 5,582 | \$ 2,207 |
| Earnings (loss) per common share Basic | \$ 0.05 | \$ (0.51) | \$ (1.12) | \$ (0.52) | \$ (1.69) | \$ 0.17 | \$ 0.19 | \$ 0.07 |
| Earnings (loss) per common share Diluted | \$ 0.04 | \$ (0.51) | \$ (1.12) | \$ (0.52) | \$ (1.69) | \$ 0.17 | \$ 0.18 | \$ 0.07 |

Table of Contents**Liquidity and Capital Resources*****Cash, Cash Equivalents and Marketable Securities***

Our financial position includes cash, cash equivalents and marketable securities of \$84.3 million at December 31, 2006 and \$12.6 million at December 31, 2005.

The discussion below highlights significant aspects of our capital resources and cash flow activities (in millions).

| | December 31, 2006 | December 31, 2005 |
|---------------------------------------|----------------------|----------------------|
| Capital resources | | |
| Cash and cash equivalents | \$ 46.5 | \$ 12.6 |
| Marketable securities | 37.8 | |
| Total | \$ 84.3 | \$ 12.6 |
| | | |
| | December 31, 2006 | December 31, 2005 |
| Cash flow activities | | |
| Net cash provided (used) by: | | |
| Operating activities | \$ 19.1 | \$ 11.5 |
| Investing activities | (40.0) | (3.3) |
| Financing activities | 54.8 | (1.4) |
| Increase in cash and cash equivalents | \$ 33.9 | \$ 6.8 |

The discussion below highlights significant aspects of our cash flows.

Operating Activities

Since our inception in August 2001, we have funded our operations primarily from cash flows generated by our operating activities. Net cash from operations in 2006, 2005 and 2004 was approximately \$19.1 million, \$11.5 million and \$10.2 million, respectively.

For the year ended December 31, 2006, we generated net cash from operations of approximately \$19.1 million from a net loss of approximately \$28.4 million. Significant non-cash charges included in the net loss that did not impact our net cash from operations during this period include depreciation and amortization of \$2.2 million, \$0.3 million for the write-off of financing fees related to our loan agreement with Comerica Bank, stock compensation expense of \$6.0 million and \$44.2 million from the change in fair value of our redeemable preferred stock conversion feature.

For the fiscal year ended December 31, 2005, we generated net cash from operations of approximately \$11.5 million from a net loss of approximately \$30.0 million. Significant non-cash charges included in the net loss that did not impact our net cash from operations during this period include depreciation and amortization of \$1.4 million, stock compensation expense of \$4.2 million and \$39.7 million from the change in fair value of our redeemable preferred stock conversion feature.

The changes in our operating assets and liabilities, net of acquisitions, and the associated impacts on our net cash from operations during the fiscal year ended December 31, 2006 as compared to the changes during the fiscal year ended December 31, 2005 are primarily due to the following factors:

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-K

Accounts Receivable. Accounts receivable increased by \$2.5 million during the twelve months ended December 31, 2006 compared to a \$3.7 million increase during the twelve months ended December 31, 2005. Increases in accounts receivable decrease cash from operations. This change was attributable

Table of Contents

primarily to increased service revenues during the year ended December 31, 2006, offset by a decrease in our days sales outstanding, or DSO, from 50 to 46. We calculate our DSO based upon a three month average of accounts receivable and revenue. The decrease in our DSO was primarily due to improved turnaround of invoicing associated with our implementation of an automated billing system. We completed implementation of this automated billing process in September 2005 and believe it, together with an increased focus on the collection process, has enabled us to prepare and deliver invoices more quickly.

Accounts Payable and Accrued Expenses. Accounts payable and accrued expenses increased by \$3.5 million during the year ended December 31, 2006 compared to a \$1.7 million increase during the year ended December 31, 2005. Increases in accounts payable and accrued expenses increase cash from operations. This increase was primarily due to the expansion of our operations and the recording of additional malpractice reserves.

Prepaid Expenses and Other Assets. Our prepaid expense and other assets increased by \$1.3 million during the year ended December 31, 2006 compared to an increase of \$1.9 million during the year ended December 31, 2005. Increases in prepaid expenses and other assets decrease cash from operations. This change was due primarily to an increase in prepaid income taxes and accrued interest receivable.

Deferred Income Taxes. Deferred income taxes increased by approximately \$3.4 million during the year ended December 31, 2006 compared to an increase of approximately \$0.8 million during the year ended December 31, 2005. The increase is primarily due to an increase in reserves and non-deductible stock compensation expense in 2006.

Investing Activities

Net cash used in investing activities was \$40.0 million for the year ended December 31, 2006 compared to \$3.3 million for the year ended December 31, 2005. Investments in marketable securities with maturities greater than ninety days are classified as investing activities on the Consolidated Statement of Cash Flows. This increase in net cash used in investing activities over this period resulted primarily from the purchase of \$84.8 million in marketable securities from a portion of the net cash proceeds received from our initial public offering. We also received \$47.7 million as a result of certain of our investments reaching maturity during the year ended December 31, 2006. We also invested approximately \$2.9 million in property and equipment during each of the years ended December 31, 2006 and 2005. The majority of these capital expenditures were associated with purchases of equipment and the continued investment in our information technology infrastructure.

Financing Activities

Net cash provided by financing activities was \$54.8 million for the year ended December 31, 2006. During the first quarter of 2006 we completed our initial public offering from which we received net proceeds of \$84.7 million after deducting discounts and commissions paid to our underwriters and approximately \$1.6 million in stock issuance costs paid during the year.

On January 2, 2006, we paid a regularly scheduled debt payment to Comerica Bank in the amount of approximately \$1.1 million. On February 8, 2006, we borrowed an additional \$7.0 million under our term loan facility and distributed the full amount as a special dividend to the holders of our common stock and our then-outstanding redeemable convertible preferred stock. On February 14, 2006, we repaid in full the outstanding principal with Comerica Bank in the amount of approximately \$29.9 million with proceeds from our initial public offering. After repaying this outstanding debt, we terminated our term and revolving loan facilities with Comerica Bank.

Net cash used in financing activities was \$1.4 million for the year ended December 31, 2005. In April 2005, we entered into a term loan facility and revolving line of credit with Comerica Bank pursuant to a loan and

Table of Contents

security agreement, the proceeds from which we used to repay all outstanding indebtedness under the promissory notes held by entities affiliated with Summit Partners and the revolving credit facility with Silicon Valley Bank. In June 2005, we paid \$750,000 to Comerica Bank as our first principal payment under our term loan facility. In August 2005 we amended our term credit facility with Comerica Bank to provide for an additional \$20 million of indebtedness. We borrowed an aggregate of \$13 million under our term facility and distributed the amount as a special dividend to our common and preferred stockholders.

Financial condition and liquidity

We expect our long-term liquidity needs to consist primarily of working capital, capital expenditure requirements and future acquisitions. We intend to fund these long-term liquidity needs from cash generated from operations. However, our ability to generate cash is subject to our performance, general economic conditions, industry trends and other factors. Many of these factors are beyond our control and cannot be anticipated at this time. To the extent that funds generated by our initial public offering, together with existing cash and securities and cash from operations, are insufficient to fund our future activities, we may need to raise additional funds through public or private equity or debt financing. If additional funds are obtained by issuing equity securities, substantial dilution to existing stockholders may result. Other than our agreement with ATN and our recently-closed acquisition of Teleradiology Diagnostic Service, Inc., we do not currently have any obligations pursuant to any agreement or binding letter of intent with respect to potential investments in, or acquisitions of, complementary businesses, services or technologies. However, we may enter into these types of arrangements in the future, which could also require us to seek additional equity or debt financing. Additional funds may not be available on terms favorable to us or at all.

Off-Balance Sheet Arrangements and Contractual Obligations**Off-Balance Sheet Arrangements**

Our Sydney office lease and our medical liability insurance policy are collateralized by separate letters of credit totaling approximately \$0.6 million and \$0.5 million as of December 31, 2006 and 2005, respectively.

Contractual Obligations

The following table presents a summary of our contractual obligations as of December 31, 2006

| | Payments Due Within | | | | Total |
|-------------------------------|---------------------|--------------|--------------|-------------------|--------------|
| | Less than 1 Year | 1-3 Years | 3-5 Years | More than 5 Years | |
| Operating lease commitments | \$ 1,297,809 | \$ 2,164,058 | \$ 1,330,761 | \$ 2,229,885 | \$ 7,022,513 |
| Total contractual obligations | \$ 1,297,809 | \$ 2,164,058 | \$ 1,330,761 | \$ 2,229,885 | \$ 7,022,513 |

Recently Adopted Accounting Standards

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123(R) which is a revision of SFAS No. 123. SFAS No. 123(R) supersedes Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employee* (APB 25), and its related implementation guidance. SFAS No. 123(R) requires all entities to recognize compensation expense in an amount equal to the fair value of share-based payments. In accordance with SFAS No. 123(R), the Company expenses the fair value of all employee stock option awards in the Company's statement of operations, typically, over the related vesting period of the options. SFAS No. 123(R) requires use of fair value to measure share-based awards issued to employees, computed at the date of grant. The Company adopted SFAS No. 123(R) as of January 1, 2006 and the adoption did not have a material effect on the Company's financial position or results of operation.

Table of Contents

In December 2004, the FASB issued SFAS No. 153, *Exchanges of Nonmonetary Assets – An Amendment of APB Opinion No. 29, Accounting for Nonmonetary Transactions*. SFAS No. 153 eliminates the exception from fair value measurement for nonmonetary exchanges of similar productive assets in paragraph 21(b) of APB Opinion No. 29 and replaces it with an exception for exchanges that do not have commercial substance. SFAS No. 153 specifies that a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS No. 153 is effective for the fiscal periods beginning after June 15, 2005. The Company adopted SFAS No. 153 as of January 1, 2006 and the adoption did not have a material effect on the Company's financial position or results of operation.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections – a replacement of APB Opinion No. 20 and FASB Statement No. 3*. SFAS No. 154 changes the requirements for the accounting for and reporting of a change in accounting principle and applies to all voluntary changes in accounting principles. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions should be followed. The provisions of SFAS No. 154 are effective for fiscal years beginning after December 15, 2005. The Company adopted SFAS No. 154 as of January 1, 2006 and the adoption did not have a material effect on the Company's financial position or results of operation.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 (SAB 108), to address diversity in practice in quantifying financial statement misstatements. SAB 108 requires that the Company quantify misstatements based on their impact on each of its financial statements and related disclosures. SAB 108 is to become effective for fiscal years ending after November 15, 2006. The Company adopted SAB 108 during the fourth quarter of 2006. The adoption of this bulletin did not have a material impact on the Company's financial position or results of operation.

Recently Issued Accounting Standards

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109* (FIN 48), which clarifies the accounting for uncertainty in tax positions. FIN 48 requires the recognition in the financial statements, the impact of a tax position, if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The provisions of FIN 48 are effective as of January 1, 2007, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. The Company has not yet completed its evaluation of the impact of adoption on the Company's financial position or results of operation.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value according to accounting principles generally accepted in the United States, and expands disclosure requirements regarding fair value measurements. This statement emphasizes that fair value should be determined based on assumptions market participants would use to price the asset or liability. The provisions of SFAS No. 157 are effective as of January 1, 2008. The Company is currently evaluating the impact of adopting SFAS No. 157 on the Company's financial position or results of operation.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159) which permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. SFAS 159 will be effective for the Company on January 1, 2008. The Company is currently evaluating the impact of adopting SFAS 159 on its financial position or results of operation.

Table of Contents

ITEM 7A. Quantitative and Qualitative Disclosures about Market Risk

Foreign Currency Exchange Risk

Although most of our affiliated radiologists work from our centralized reading facilities in Australia and Switzerland, the professional service fees we pay to our affiliated radiologists are denominated primarily in U.S. dollars. As a result, only our operating leases in those countries present foreign currency exchange risks. Because we are not currently subject to material foreign currency exchange risk, we have not, to date, entered into any hedging contracts. If a weakening U.S. dollar requires us to increase the amounts we pay to our affiliated radiologists in the future in order to maintain a constant level of compensation denominated in U.S. dollars, our results of operations and cash flows could be affected. Any foreign exchange risks are related to the foreign currency exchange rates between the U.S. dollar and the Australian dollar and between the U.S. dollar and the Swiss franc.

Interest Rate Sensitivity

We had cash and cash equivalents totaling \$46.5 million at December 31, 2006 and \$12.6 million at December 31, 2005. These amounts were invested primarily in interest-bearing money market accounts. Additionally, we had marketable securities totaling \$37.8 million at December 31, 2006 invested primarily in U.S. government agency securities and municipal securities. The cash and cash equivalents are held for working capital purposes. We do not enter into investments for trading or speculative purposes. We believe that we do not have any material exposure to changes in the fair value of our investment portfolio as a result of changes in interest rates. However, any declines in interest rates will reduce future investment income.

Table of Contents

ITEM 8. Financial Statements and Supplementary Data

INDEX TO FINANCIAL STATEMENTS

| | Page |
|---|-------------|
| NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES | |
| Consolidated Financial Statements: | |
| <u>Report of Independent Registered Public Accounting Firm</u> | 59 |
| <u>Consolidated Balance Sheets</u> | 60 |
| <u>Consolidated Statements of Operations</u> | 61 |
| <u>Consolidated Statements of Members And Stockholders Equity (Deficit)</u> | 62 |
| <u>Consolidated Statements of Cash Flows</u> | 63 |
| <u>Notes to Consolidated Financial Statements</u> | 65 |
| <u>Schedule II Consolidated Valuation and Qualifying Accounts</u> | 89 |

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of

NightHawk Radiology Holdings, Inc. and subsidiaries

Coeur d'Alene, Idaho

We have audited the accompanying consolidated balance sheets of NightHawk Radiology Holdings, Inc. and subsidiaries (the Company) as of December 31, 2006 and 2005, and the related consolidated statements of operations, members' and stockholders' equity (deficit), and cash flows for each of the three years in the period ended December 31, 2006. Our audit also included the consolidated financial statement schedule listed in the Index at Item 8. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of NightHawk Radiology Holdings, Inc. and subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such consolidated financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

As discussed in Note 1 to the financial statements, the Company was recapitalized in March 2004.

/s/ DELOITTE AND TOUCHE, LLP

Boise, Idaho

March 1, 2007

Table of Contents**NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

| | December 31, | |
|---|----------------|---------------|
| | 2006 | 2005 |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 46,500,818 | \$ 12,610,487 |
| Marketable securities | 37,810,963 | |
| Trade accounts receivable, net | 12,706,146 | 10,485,571 |
| Deferred income taxes | 365,930 | 19,839 |
| Prepaid expenses and other current assets | 2,076,037 | 2,164,126 |
| Total current assets | 99,459,894 | 25,280,023 |
| Property and equipment, net | 6,192,541 | 5,079,280 |
| Goodwill | 4,913,844 | 1,335,788 |
| Intangible assets, net | 2,922,543 | 3,431,418 |
| Deferred income taxes | 2,480,972 | |
| Other assets, net | 96,572 | 409,253 |
| Total | \$ 116,066,366 | \$ 35,535,762 |
| LIABILITIES | | |
| Current liabilities: | | |
| Accounts payable and accrued expenses | \$ 9,052,634 | \$ 5,502,977 |
| Dividends declared | | 7,000,000 |
| Accrued payroll and related benefits | 2,383,998 | 2,366,430 |
| Accrued interest payable | | 424,601 |
| Long-term debt, due within one year | | 6,229,991 |
| Total current liabilities | 11,436,632 | 21,523,999 |
| Insurance reserve | 2,000,000 | |
| Long-term debt | | 17,773,438 |
| Fair value of redeemable preferred stock conversion feature | | 45,256,250 |
| Deferred income taxes | | 630,303 |
| Total liabilities | 13,436,632 | 85,183,990 |
| Commitments and contingencies (Note 8) | | |
| Redeemable common stock | | 15,356,253 |
| Redeemable convertible preferred stock | | 13,156,916 |
| STOCKHOLDERS EQUITY (DEFICIT): | | |
| Common stock 150,000,000 shares authorized; \$.001 par value; 29,944,069 and 15,838,139 shares issued and outstanding at December 31, 2006 and 2005 | 29,944 | 15,838 |
| Additional paid-in capital | 230,116,635 | 9,434,351 |
| Retained earnings (deficit) | (127,516,845) | (87,611,586) |
| Total stockholders equity (deficit) | 102,629,734 | (78,161,397) |
| Total | \$ 116,066,366 | \$ 35,535,762 |

The accompanying notes are an integral part of the consolidated financial statements.

Table of Contents**NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS**

| | For the Years Ended December 31, | | |
|---|---|-----------------|---------------|
| | 2006 | 2005 | 2004 |
| Service revenue | \$ 92,168,246 | \$ 64,061,528 | \$ 39,283,002 |
| Operating costs and expenses: | | | |
| Professional services (includes non-cash compensation expense of \$4,886,678, \$916,170 and \$1,544,781) | 38,963,287 | 22,401,184 | 15,049,399 |
| Sales, general, and administrative (includes non-cash compensation expense of \$1,073,455, \$3,273,018 and \$144,822) | 27,607,317 | 22,988,027 | 11,991,386 |
| Depreciation and amortization | 2,198,714 | 1,350,536 | 528,126 |
| Total operating costs and expenses | 68,769,318 | 46,739,747 | 27,568,911 |
| Operating income | 23,398,928 | 17,321,781 | 11,714,091 |
| Other income (expense): | | | |
| Interest expense | (562,221) | (1,178,323) | (880,671) |
| Interest income | 3,027,917 | 67,072 | 40,835 |
| Other, net | (34,258) | (51,147) | (28,953) |
| Change in fair value of redeemable preferred stock conversion feature | (44,183,770) | (39,728,473) | (3,857,500) |
| Total other income (expense) | (41,752,332) | (40,890,871) | (4,726,289) |
| Income (loss) before income taxes | (18,353,404) | (23,569,090) | 6,987,802 |
| Income tax expense | 10,047,713 | 6,391,302 | 3,662,563 |
| Net income (loss) | (28,401,117) | (29,960,392) | 3,325,239 |
| Redeemable preferred stock accretion | (117,534) | (1,062,451) | (764,742) |
| Preferred dividends | | (5,486,555) | |
| Net income (loss) applicable to common stockholders | \$ (28,518,651) | \$ (36,509,398) | \$ 2,560,497 |
| Earnings (loss) per common share: | | | |
| Basic and diluted | \$ (1.00) | \$ (2.11) | \$ 0.11 |
| Weighted average of common shares outstanding: | | | |
| Basic and diluted | 28,528,079 | 17,273,970 | 24,196,437 |

The accompanying notes are an integral part of the consolidated financial statements.

Table of Contents**NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF MEMBERS AND STOCKHOLDERS EQUITY (DEFICIT)**

| | Common Stock | | | Members Equity | Retained | |
|--|--------------|-----------|-----------------------------------|-------------------|-----------------------|-----------------|
| | Shares | Amount | Additional Paid- in Capital | | Earnings (Deficit) | Total |
| Balance January 1, 2004 | | | | \$ 915,815 | \$ 4,718,315 | \$ 5,634,130 |
| Net income | | | | | 3,325,239 | 3,325,239 |
| Redemption of member's units | | | | (556,293) | (743,707) | (1,300,000) |
| Distributions to members | | | | | (2,885,259) | (2,885,259) |
| Recapitalization of the Company | 15,042,860 | \$ 15,043 | \$ 3,761 | | (26,135,903) | (26,117,099) |
| Stock contributed by stockholders | (1,646,376) | (1,646) | 1,646 | | | |
| Issuance of common stock to non-employees | 1,007,500 | 1,007 | 1,812,492 | (359,522) | | 1,453,977 |
| Issuance of restricted stock to non-employees | 638,876 | 639 | 99,781 | | | 100,420 |
| Issuances of stock options employees | | | 44,403 | | | 44,403 |
| Issuances of stock options non-employees | | | 45,572 | | | 45,572 |
| Stock compensation paid by principal stockholders | | | 45,231 | | | 45,231 |
| Stock issued in acquisition | 480,000 | 480 | 863,520 | | | 864,000 |
| Accretion of redeemable common stock | | | | | (3,154,822) | (3,154,822) |
| Accretion of redeemable preferred stock | | | | | (764,742) | (764,742) |
| Balance December 31, 2004 | 15,522,860 | \$ 15,523 | \$ 2,916,406 | \$ | \$ (25,640,879) | \$ (22,708,950) |
| Net loss | | | | | (29,960,392) | (29,960,392) |
| Issuance of restricted stock to non-employees | | | 2,926,255 | | | 2,926,255 |
| Issuance of stock options employees | | | 346,763 | | | 346,763 |
| Issuance of stock options non-employees | | | 916,170 | | | 916,170 |
| Stock issued in acquisition | 315,279 | 315 | 2,328,757 | | | 2,329,072 |
| Accretion of redeemable common stock | | | | | (10,947,864) | (10,947,864) |
| Accretion of redeemable preferred stock | | | | | (1,062,451) | (1,062,451) |
| Dividends paid (\$.549 per common and preferred share) | | | | | (13,000,000) | (13,000,000) |
| Dividends declared (\$.295 per common and preferred share) | | | | | (7,000,000) | (7,000,000) |
| Balance December 31, 2005 | 15,838,139 | \$ 15,838 | \$ 9,434,351 | \$ | \$ (87,611,586) | \$ (78,161,397) |
| Net loss | | | | | (28,401,117) | (28,401,117) |
| Shares issued upon exercise of stock options | 134,498 | 134 | 403,469 | | | 403,603 |
| Issuance of stock options employees | | | 879,875 | | | 879,875 |
| Issuance of stock options non-employees | | | 5,080,258 | | | 5,080,258 |
| Issuance of stock initial public offering | 5,800,000 | 5,800 | 86,298,200 | | | 86,304,000 |
| Stock issuance costs | | | (2,112,365) | | | (2,112,365) |
| Conversion of redeemable preferred stock | 6,500,003 | 6,500 | 13,267,950 | | | 13,274,450 |
| Reclassification of redeemable common stock | 1,671,429 | 1,672 | 26,741,189 | | | 26,742,861 |
| Termination of redeemable preferred stock conversion feature | | | 89,440,020 | | | 89,440,020 |
| Accretion of redeemable common stock | | | | | (11,386,608) | (11,386,608) |
| Accretion of redeemable preferred stock | | | | | (117,534) | (117,534) |
| Excess tax benefit from stock options exercised | | | 683,688 | | | 683,688 |
| Balance December 31, 2006 | 29,944,069 | \$ 29,944 | \$ 230,116,635 | \$ | \$ (127,516,845) | \$ 102,629,734 |

The accompanying notes are an integral part of the consolidated financial statements.

Table of Contents**NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS**

| | For the Years Ended December 31, | | |
|--|---|--------------------|--------------------|
| | 2006 | 2005 | 2004 |
| Cash flows from operating activities: | | | |
| Net income (loss) | \$ (28,401,117) | \$ (29,960,392) | \$ 3,325,239 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation and amortization | 2,198,714 | 1,350,536 | 528,126 |
| Accretion of discounts on marketable securities | (634,848) | | |
| Other loss | 365,024 | 22,748 | |
| Deferred income taxes | (3,418,406) | (771,922) | 154,180 |
| Change in fair value of redeemable preferred stock conversion feature | 44,183,770 | 39,728,473 | 3,857,500 |
| Non-cash stock compensation expense | 5,960,133 | 4,189,188 | 1,689,603 |
| Excess tax benefit from exercise of stock options | (683,688) | | |
| Provision for doubtful accounts and sales credits | 256,503 | 310,178 | |
| Changes in operating assets and liabilities (excluding effects of acquisitions): | | | |
| Trade accounts receivable | (2,477,078) | (3,717,638) | (2,764,779) |
| Prepaid expenses and other assets | (1,355,059) | (1,941,686) | (117,983) |
| Accounts payable and accrued expenses | 3,543,763 | 1,652,384 | 1,699,444 |
| Accrued payroll and related benefits | 17,568 | 490,297 | 1,625,364 |
| Accrued interest payable | (424,601) | 176,382 | 248,219 |
| Net cash provided by operating activities | 19,130,678 | 11,528,548 | 10,244,913 |
| Cash flows from investing activities: | | | |
| Purchase of marketable securities | (84,823,115) | | |
| Proceeds from maturities of marketable securities | 47,647,000 | | |
| Purchase of property and equipment | (2,872,419) | (2,841,764) | (2,213,459) |
| Acquisition of DayHawk, net of cash acquired of \$119,618 | | | (630,382) |
| Payment of amount related to DayHawk acquisition | | (500,000) | |
| Cash received from ATN acquisition | | 36,695 | |
| Net cash used in investing activities | (40,048,534) | (3,305,069) | (2,843,841) |
| Cash flows from financing activities: | | | |
| Borrowings from (repayments to) line of credit | | (3,000,000) | 3,000,000 |
| Proceeds from note payable and debt | 7,000,000 | 25,780,900 | 12,000,000 |
| Repayment of notes payable and debt | (31,003,429) | (11,207,753) | (3,260,000) |
| Proceeds from issuance of common stock, net of issuance costs | 84,724,323 | | |
| Proceeds from exercise of stock options | 403,605 | | |
| Excess tax benefit from exercise of stock options | 683,688 | | |
| Purchase of membership units | | | (24,185,672) |
| Expenses related to recapitalization | | | (1,463,527) |
| Proceeds from issuance of preferred stock | | | 13,000,000 |
| Distributions to members | | | (2,862,132) |
| Dividends paid | (7,000,000) | (13,000,000) | |
| Net cash provided by (used in) financing activities | 54,808,187 | (1,426,853) | (3,771,331) |
| Net increase in cash and cash equivalents | 33,890,331 | 6,796,626 | 3,629,741 |
| Cash and cash equivalents beginning of year | 12,610,487 | 5,813,861 | 2,184,120 |

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-K

| | | | |
|---------------------------------------|---------------|---------------|--------------|
| Cash and cash equivalents end of year | \$ 46,500,818 | \$ 12,610,487 | \$ 5,813,861 |
|---------------------------------------|---------------|---------------|--------------|

Table of Contents**NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)**

| | For the Years Ended December 31, | | |
|--|----------------------------------|----------------|----------------|
| | 2006 | 2005 | 2004 |
| Supplemental disclosures of cash flow information: | | | |
| Cash paid for interest | \$ 648,236 | \$ 963,794 | \$ 632,452 |
| Cash paid for income taxes | \$ 14,119,091 | \$ 6,689,743 | \$ 3,366,775 |
| Non-cash investing and financing activities: | | | |
| Accretion of redeemable preferred stock | \$ 117,534 | \$ 1,062,451 | \$ 764,742 |
| Accretion of redeemable common stock | \$ 11,386,608 | \$ 10,947,864 | \$ 3,154,822 |
| Conversion of redeemable convertible preferred stock | \$ 13,274,450 | | |
| Conversion of redeemable common stock | \$ 26,742,861 | | |
| Termination of preferred stock conversion feature | \$ 89,440,020 | | |
| Stock issuance costs paid in 2005 reclassified to additional paid-in capital | \$ 532,686 | | |
| Purchases of equipment included in accounts payable | \$ 78,441 | \$ 22,114 | |
| Prepayment of expenses with notes payable | | \$ 780,900 | |
| Dividends declared and not paid | | \$ 7,000,000 | |
| Stock issuance costs included in accounts payable and accrued expenses | | \$ 900,767 | |
| Common stock issued in recapitalization | | | \$ 18,804 |
| Distributions payable to former LLC member | | | \$ 23,127 |
| Details of ATN acquisition: | | | |
| Receivables | | \$ (1,005,609) | |
| Other assets | | \$ (257,435) | |
| Property and equipment | \$ 105,991 | \$ (293,183) | |
| Deferred income tax assets | | \$ (71,592) | |
| Goodwill | \$ (3,578,056) | \$ (381,000) | |
| Intangible assets | | \$ (2,680,000) | |
| Accounts payable and other liabilities | | \$ 666,215 | |
| Deferred income tax liabilities | \$ (38,960) | \$ 1,299,945 | |
| Notes payable assumed | | \$ 430,282 | |
| Issuance of common stock | | \$ 2,329,072 | |
| Contingently issuable common stock | \$ 3,511,025 | | |
| Net cash received in acquisition | \$ 0 | \$ 36,695 | |
| Details of DayHawk acquisition: | | | |
| Receivables | | | \$ (472,037) |
| Other assets | | | \$ (26,038) |
| Goodwill | | | \$ (954,788) |
| Intangible assets | | | \$ (1,040,000) |
| Accounts payable and other accrued expenses | | | \$ 238,481 |
| Notes payable assumed | | | \$ 260,000 |
| Payable to seller | | | \$ 500,000 |
| Issuance of common stock | | | \$ 864,000 |
| Net cash paid for acquisition | | | \$ (630,382) |

The accompanying notes are an integral part of the consolidated financial statements.

Table of Contents

NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

1. THE COMPANY

Background NightHawk Radiology Holdings, Inc., a Delaware corporation (the Company), is a provider of radiology services to radiology groups and hospitals across the United States. The Company's general offices are located in Coeur d'Alene, Idaho and its primary reading facilities are in Sydney, Australia and Zurich, Switzerland. The Company's functional currency is the U.S. dollar. The Company has a single reporting segment and reporting unit structure.

On February 8, 2006, a registration statement relating to the Company's initial public offering of its common stock was declared effective by the Securities and Exchange Commission. Under this registration statement, the Company registered and sold 5,800,000 shares of its common stock, and another 1,445,000 shares of its common stock held by certain selling stockholders. All shares of common stock issued pursuant to the registration statement were sold at a price of \$16.00 per share.

As of December 31, 2006, the legal entity structure for the Company is as follows:

NightHawk Radiology Holdings, Inc. A Delaware corporation formed in March 2004.

Nighthawk Radiology Services, LLC An Idaho limited liability company formed in May 2001 which is a wholly owned subsidiary of NightHawk Radiology Holdings, Inc.

NightHawk Services GmbH A wholly owned subsidiary of Nighthawk Radiology Services, LLC formed in September 2004 and located in Zurich, Switzerland.

DayHawk Radiology Services, LLC A Delaware limited liability company, an unrelated party, acquired in November 2004, which is a wholly owned subsidiary of NightHawk Radiology Holdings, Inc.

American Teleradiology Nighthawks, Inc. A Delaware corporation formed in May 2003, acquired in September 2005, which is a wholly-owned subsidiary of Nighthawk Radiology Holdings, Inc.

The consolidated financial statements include the assets, liabilities and results of operations of all the preceding entities. As discussed in Note 3, the results of operations of DayHawk Radiology Services, LLC and American Teleradiology Nighthawks, Inc. have been included in the Company's consolidated financial statements since the date of each respective acquisition.

Recapitalization Until March 2004, the Company operated as Nighthawk Radiology Services, LLC, an Idaho limited liability company (the LLC). The Company was recapitalized in March 2004 and NightHawk Radiology Holdings, Inc. was formed for the purpose of acquiring all of the outstanding units of the LLC and all of the outstanding shares of NRS Corporation, whose only assets were outstanding units of the LLC.

The significant aspects of the recapitalization were as follows:

As of December 31, 2003, the LLC was authorized to issue up to 2,000 common membership units and 1,000 preferred membership units. As of December 31, 2003, total outstanding common and preferred membership units were 999 and 0 units, respectively.

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-K

On January 2, 2004, the LLC redeemed 56 membership units owned by one member for \$1,300,000 in cash.

Table of Contents

On March 31, 2004, the Company, the LLC, and certain members of the LLC entered into a Securities Purchase and Contribution Agreement with an investment firm pursuant to which the Company sold debt and equity securities to raise capital to fund the purchase of LLC membership units held by a selling member of the LLC. The investment firm purchased securities of the new Company for \$25,000,000, consisting of \$12,000,000 of subordinated debt (see Note 7) issued by the LLC and \$13,000,000 of the Company's Series A Convertible Redeemable Preferred Stock (6,500,003 shares).

Proceeds from the investment firm's \$25,000,000 investment were used as follows:

\$23,400,000 to purchase 607.25 membership units owned by a selling member.

\$1,463,527 to fund recapitalization transaction expenses.

\$136,473 for general working capital purposes.

As part of this recapitalization, certain LLC members who were also executive officers of the LLC exchanged their 335.75 membership units for 16,714,286 shares of common stock of the Company (which includes 1,671,429 shares of redeemable common stock as discussed in Note 13). As a result of the preceding transactions, the Company was capitalized with 6,500,003 shares of Series A preferred stock and 16,714,286 shares of common stock. The rights, preferences and privileges of the preferred and common stockholders are described in Note 13.

In accordance with Statement of Financial Accounting Standards (SFAS) SFAS No. 141, *Business Combinations*, the Company analyzed the transaction and concluded that no change in control occurred. Consequently, the transaction was accounted for as a recapitalization. Significant factors considered in this analysis included relative voting rights, composition of governing body, and composition of senior management as set forth in the applicable charter documents and governing stockholder agreements. The conclusion that no change in control occurred was determined after analyzing these factors both prior to (LLC), and subsequent to, the transaction.

In June 2004 an aggregate of 638,876 shares of common stock of the Company and in November 2004 an aggregate of 1,007,500 shares of common stock of the Company were contributed to the Company by the stockholders who previously exchanged their membership units in the LLC for common stock of the Company (see above). These stockholders did not receive any consideration for this stock. The common stock contributed to the Company in June 2004 was issued by the Company pursuant to a restricted stock grant to a person who subsequently became a member of the Company's board of directors and the common stock contributed to the Company in November 2004 was issued by the Company pursuant to a stock grant to an affiliated radiologist who had previously been granted a warrant to purchase units in the LLC in 2003.

Through March 31, 2004, allocations of net profits and losses, calculated in accordance with the LLC agreement, were made in accordance with the members' percentage interest. The Company made distributions to the members in proportion to their percentage interests. Additionally, quarterly distributions were made to the members of the Company (based on their percentage interests) for their estimated federal and state income tax liabilities.

The accompanying financial statements include the presentation of consolidated financial statements of NightHawk Radiology Holdings, Inc. since March 31, 2004 and the financial statements of Nighthawk Radiology Services, LLC for the periods prior to March 31, 2004. Both the Company and the LLC are collectively referred herein as the Company.

Table of Contents

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany transactions have been eliminated.

Use of Estimates The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Some of these estimates require difficult, subjective or complex judgments about matters that are inherently uncertain. Actual results could differ from those estimates.

On an ongoing basis, the Company evaluates its estimates, including those related to the accounts receivable allowance, fair value of acquired intangible assets and goodwill, fair value of redeemable preferred stock conversion feature, useful lives of intangible assets and property and equipment, income taxes, the loss contingency for medical liability claims and estimates used for the purpose of determining stock-based compensation.

Cash and Cash Equivalents The Company considers all highly liquid investments with a remaining maturity of three months or less at the date of purchase to be cash equivalents.

Trade Accounts Receivable Trade accounts receivable represent receivables for radiology services and are recorded at the invoiced amount and are non-interest bearing. The Company has a history of minimal uncollectible receivables. Management reviews past due accounts receivable to identify specific customers with known disputes or collectibility issues. As of December 31, 2006 and 2005, the Company had reserved approximately \$380,000 and \$312,000, respectively, for doubtful accounts based on its estimate of the collectibility of outstanding receivables as of those dates.

Marketable Securities The appropriate classification of investments in marketable debt and equity securities at the time of purchase and reevaluates such designation at each balance sheet date. Marketable debt and equity securities have been classified and accounted for as available for sale. The Company may or may not hold securities with stated maturities greater than twelve months until maturity. In response to changes in the availability of and the yield on alternative investments as well as liquidity requirements, the Company occasionally sells these securities prior to their stated maturities. The Company expects that the majority of marketable securities will be sold within one year, regardless of maturity date. The Company primarily invests in high-credit-quality debt instruments with an active resale market and money market funds to ensure liquidity and the ability to readily convert these investments into cash to fund current operations, or satisfy other cash requirements as needed. Accordingly, all marketable securities have been classified as current assets in the accompanying balance sheets. These securities are carried at fair value, with the unrealized gains and losses, net of taxes, reported as a component of stockholders' equity, except for unrealized losses determined to be other than temporary which are recorded as interest expense. Any realized gains or losses on the sale of marketable securities are determined on a specific identification method, and such gains and losses are reflected as a component of interest income or expense.

Property and Equipment Property and equipment are stated at cost. Depreciation is provided using the straight-line method over the estimated useful lives of each asset, which ranges as follows:

| | |
|---|---|
| Computers, diagnostic workstations and telecommunications systems | 5-7 years |
| Office furniture and equipment | 7-10 years |
| Software | 3-7 years |
| Leasehold improvements | Term of lease or asset life, whichever is shorter |

Table of Contents

Expenditures for maintenance and repairs are charged to operating expense as incurred and expenditures for renewals and betterments are capitalized. Upon sale or retirement of depreciable assets, the related cost and accumulated depreciation are removed from the records and any gain or loss is reflected in operating expenses.

Cost of computer software used for internal use is capitalized and accounted for in accordance with Statement of Position 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. Capitalized costs are amortized based on the Company's expected utilization of existing internally developed software.

Medical Liability Insurance The Company is exposed to various risks of loss related to litigation that may arise related to malpractice and maintains insurance for medical liabilities in amounts considered adequate by Company management. The Company's claims-made policy provides coverage up to the policy limits for claims filed within the period of the policy term, subject to deductible requirements. Coverage for affiliated radiologists is initiated when they begin providing services on behalf of the Company.

The Company records reserves for both reported and incurred but not reported (IBNR) amounts. Reported amounts are reserved based upon the Company's best estimate of future probable costs. IBNR claims are estimated by a third party using historical claims lag information received by our third party claims administrator and industry indices. Due to the uncertainty of health claims, the shortness of claim history and the young age of the teleradiology industry, the Company had not been able to estimate this cost in prior years. This reserve is intended to cover potential medical claims that might arise related to all of the radiological interpretations performed by the company's doctors since inception.

Operating Leases The Company leases various office space under operating leases. Certain lease arrangements contain rent escalation clauses for which the lease expense is recognized on a straight-line method over the term of the leases.

Long-Lived Assets Including Goodwill and Other Acquired Intangible Assets The value of goodwill and intangible assets is stated at the lower of cost or fair value. Goodwill is not subject to amortization; however it is subject to periodic impairment assessments. Under the provisions of SFAS No. 142, *Goodwill and Other Intangible Assets*, the Company is required to perform at least an annual goodwill impairment test and to consider other indicators that may arise throughout the year to re-evaluate carrying value. To the extent carrying value exceeds fair value at the date impairment is tested, the Company reduces goodwill by recording a charge to operations. The annual impairment test is performed as of October 1 of each fiscal year and the conclusion was reached that goodwill was not impaired at October 1, 2006 or 2005. Goodwill impairment tests will continue to be performed at least annually and more frequently if circumstances indicate a possible impairment. SFAS No. 142 also requires that intangible assets with definite lives be amortized over their estimated useful lives (see Note 5).

Revenue Recognition and Presentation Service revenue is recognized when all significant contractual obligations have been satisfied and collection of the resulting receivable is reasonably assured. Service revenue consists of fees for radiological interpretations and is recognized in the fiscal month when the radiological interpretation is complete and delivered to the customer.

Professional Services Expenses Professional service expenses consist primarily of the fees we pay to affiliated radiologists, any physician stock-based compensation, the premiums for medical liability insurance and any medical liability claims loss expenses. Affiliated radiologists are independent contractors compensated using a formula that is generally based upon the number of hours worked, with additional incentives for the workload completed as well as year-end discretionary bonuses. Professional services expenses are recognized in the month in which the services are performed. The Company recognizes expenses associated with medical liability premiums in the month in which the expense is incurred. The Company records medical liability loss contingency expenses in the month in which the Company deems such liability probable.

Table of Contents

Stock-Based Compensation The Company records stock-based compensation expense in connection with any grant of stock options or restricted stock units to affiliated radiologists. Beginning on January 1, 2006, the Company adopted the provisions of SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS No. 123 (R)). As a result, the Company calculates the stock-based compensation expense associated with the issuance of stock-based compensation to affiliated radiologists in accordance with SFAS No. 123 (R), and Emerging Issues Task Force Issue No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services* (EITF No. 96-18). The Company calculates the stock-based compensation expense related to the issuance of common stock or restricted stock units to affiliated radiologists based on the fair value of common stock at the date the shares or restricted stock units were earned. Stock-based compensation related to affiliated radiologists is included in professional services expenses.

The Company also records stock-based compensation expense in connection with any grant of stock options or restricted stock units to employees, directors and non-physician contractors. The Company calculates the stock-based compensation expense associated with the issuance of options or restricted stock units to our employees, directors and non-physician contractors in accordance with SFAS No. 123 (R). Stock-based compensation related to employees, directors and non-physician contractors is included in sales, general and administrative expenses.

Prior to January 1, 2006, the Company calculated the stock-based compensation expense associated with the issuance of stock-based compensation to affiliated radiologists in accordance with Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123), SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure, an amendment of FASB Statement No. 123* (SFAS No. 148) and EITF No. 96-18.

Income Taxes As previously indicated, the Company operated as a limited liability company prior to March 31, 2004. Consequently, the Company was not subject to federal income taxes. Rather, the members were subject to federal income taxation based on their respective allocation of the Company's net taxable income or loss. Accordingly, the Company did not record any current or deferred assets, liabilities, or expenses related to income taxes through March 31, 2004.

Subsequent to its recapitalization, the Company recognizes income taxes under the asset and liability method in accordance with SFAS No. 109, *Accounting for Income Taxes*. This approach requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the carrying amounts and the tax bases of assets and liabilities.

The provision for income taxes, including the effective tax rate and analysis of potential tax exposure items, if any, requires significant judgment and expertise in federal and state income tax laws, regulations and strategies, including the determination of deferred tax assets and liabilities and any estimated valuation allowances deemed necessary to value deferred tax assets. The Company's judgment and tax strategies are subject to audit by various taxing authorities. While the Company believes it has provided adequately for its income tax liabilities in the consolidated financial statements, adverse determinations by these taxing authorities could have a material adverse effect on the consolidated financial condition, results of operations or cash flows.

Earnings Per Common Share Basic earnings per common share is calculated based on the weighted-average number of outstanding common shares during the applicable period. Diluted earnings per common share are based on the weighted-average number of outstanding common shares plus the weighted-average number of potential outstanding common shares. Potential common shares that would increase earnings per share amounts or decrease loss per share amounts are antidilutive and are, therefore, excluded from the earnings per common share computations. Earnings per common share are computed separately for each period presented.

Concentration of Credit Risk Financial instruments that potentially expose the Company to concentration of credit risk consist primarily of cash and cash equivalents and accounts receivable. The Company maintains its

Table of Contents

cash and cash equivalents with high quality credit institutions. At times, such amounts may be in excess of insured amounts. As of December 31, 2006 and 2005, a total of approximately \$10,690,000 and \$13,158,000, respectively, of cash and cash equivalents was in excess of insured amounts.

Fair Value of Financial Instruments The carrying amounts of the Company's financial instruments, including cash and cash equivalents, marketable securities, accounts receivable and current liabilities approximate their fair value because of their short duration.

Derivative Financial Instruments The Company accounts for derivative financial instruments in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The Company records derivative financial instruments as assets or liabilities in the consolidated balance sheet, measured at fair value. When available, the Company uses quoted market prices to determine fair value; however, if quoted market prices are not available, the Company estimates fair value using either quoted market prices of financial instruments with similar characteristics or other valuation techniques. The Company records the changes in fair value of such instruments as non-cash gains or losses in the consolidated statements of operations. The Company does not enter into derivatives for trading purposes and has no derivative financial instruments as of December 31, 2006.

Recently Adopted Accounting Standards In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123(R) which is a revision of SFAS No. 123. SFAS No. 123(R) supersedes Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employee* (APB 25), and its related implementation guidance. SFAS No. 123(R) requires all entities to recognize compensation expense in an amount equal to the fair value of share-based payments. In accordance with SFAS No. 123(R), the Company expenses the fair value of all employee stock option awards in the Company's statement of operations, typically, over the related vesting period of the options. SFAS No. 123(R) requires use of fair value to measure share-based awards issued to employees, computed at the date of grant. The Company adopted SFAS No. 123(R) as of January 1, 2006 and the adoption did not have a material effect on the Company's financial position or results of operation.

In December 2004, the FASB issued SFAS No. 153, *Exchanges of Nonmonetary Assets - An Amendment of APB Opinion No. 29, Accounting for Nonmonetary Transactions*. SFAS No. 153 eliminates the exception from fair value measurement for nonmonetary exchanges of similar productive assets in paragraph 21(b) of APB Opinion No. 29 and replaces it with an exception for exchanges that do not have commercial substance. SFAS No. 153 specifies that a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS No. 153 is effective for the fiscal periods beginning after June 15, 2005. The Company adopted SFAS No. 153 as of January 1, 2006 and the adoption did not have a material effect on the Company's financial position or results of operation.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections - a replacement of APB Opinion No. 20 and FASB Statement No. 3*. SFAS No. 154 changes the requirements for the accounting for and reporting of a change in accounting principle and applies to all voluntary changes in accounting principles. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions should be followed. The provisions of SFAS No. 154 are effective for fiscal years beginning after December 15, 2005. The Company adopted SFAS No. 154 as of January 1, 2006 and the adoption did not have a material effect on the Company's financial position or results of operation.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 (SAB 108), to address diversity in practice in quantifying financial statement misstatements. SAB 108 requires that the Company quantify misstatements based on their impact on each of its financial statements and related disclosures. SAB 108 is to become effective for fiscal years ending after November 15, 2006. The Company adopted SAB 108 during the fourth quarter of 2006. The adoption of this bulletin did not have a material impact on the Company's financial position or results of operation.

Table of Contents

Recently Issued Accounting Standards In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No. 109 (FIN 48), which clarifies the accounting for uncertainty in tax positions. FIN 48 requires the recognition in the financial statements, the impact of a tax position, if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The provisions of FIN 48 are effective as of January 1, 2007, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. The Company has not yet completed its evaluation of the impact of adoption on the Company's financial position or results of operation.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value according to accounting principles generally accepted in the United States, and expands disclosure requirements regarding fair value measurements. This statement emphasizes that fair value should be determined based on assumptions market participants would use to price the asset or liability. The provisions of SFAS No. 157 are effective as of January 1, 2008. The Company is currently evaluating the impact of adopting SFAS No. 157 on the Company's financial position or results of operation.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159) which permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. SFAS 159 will be effective for the Company on January 1, 2008. The Company is currently evaluating the impact of adopting SFAS 159 on its financial position or results of operation.

3. ACQUISITIONS**DAYHAWK**

In November 2004, the Company completed the purchase of DayHawk Radiology Services, LLC (DayHawk), an unrelated party. The acquisition expanded the Company's presence in additional markets. DayHawk was acquired for \$1,250,000 in cash (\$750,000 paid in 2004 and \$500,000 paid in 2005), 480,000 shares of common stock with an estimated fair value of \$864,000 and the assumption of \$498,481 in liabilities for total consideration of \$2,612,481. The fair value of the common stock issued in connection with the DayHawk acquisition was determined by management with the assistance of an independent valuation specialist.

The determination of the estimated fair value of the intangible assets acquired required management to make significant estimates and assumptions, including future expected cash flows from customer contracts and customer lists, the DayHawk tradename and assumptions about the period of time such tradename will continue to be used by the Company.

The acquisition of DayHawk resulted in the assets acquired and liabilities assumed being recorded based on their estimated fair values on the acquisition date. Goodwill of \$954,788, representing the excess of the purchase price over the fair value of tangible and identifiable intangible assets acquired and liabilities assumed, will not be amortized, consistent with the guidance in SFAS No. 142. The results of operations of DayHawk have been included in the Company's consolidated statements of operations and cash flows since the date of acquisition.

The following table presents the allocation of the purchase price to the acquired assets and liabilities:

| | |
|-----------------------------|--------------|
| Current assets | \$ 600,106 |
| Furniture and fixtures | 17,587 |
| Intangible assets | 1,040,000 |
| Goodwill | 954,788 |
| Assets acquired | 2,612,481 |
| Current liabilities assumed | (498,481) |
| Net assets acquired | \$ 2,114,000 |

Table of Contents

The amount allocated to intangible assets was attributed to the following categories:

| | Acquired Value | Estimated Useful Life |
|----------------------------------|---------------------|--------------------------|
| Customer lists and relationships | \$ 740,000 | 10 years |
| Tradename and trademarks | 150,000 | 10 years |
| Customer contracts | 100,000 | 7 months |
| Noncompete agreements | 50,000 | 2 years |
| | \$ 1,040,000 | |

All intangible assets are amortized on a straight-line basis over their expected useful lives (Note 5).

The following pro forma information assumes the DayHawk acquisition occurred as of January 1, 2004. The unaudited pro forma financial information summarizes the results of operations for the year ended December 31, 2004. The pro forma results are not necessarily indicative of what would have occurred had the acquisition actually been made at the beginning of the year or of future operations of the combined companies.

| | Year Ended December 31, 2004 (unaudited) |
|--|---|
| Service revenue | \$ 41,409,715 |
| Net income | \$ 2,981,981 |
| Net income applicable to common stockholders | \$ 2,217,239 |
| Earnings per common share, basic and diluted | \$ 0.09 |

AMERICAN TELERADIOLOGY NIGHTHAWKS, INC.

On September 30, 2005, the Company completed the purchase of American Teleradiology Nighthawks, Inc. (ATN), an unrelated party. The acquisition expanded the Company's presence in additional markets. ATN was acquired for total consideration of:

315,279 shares of common stock issued on September 30, 2005 with an estimated fair value of \$2,329,072 and the assumption of \$2,345,328 in liabilities for an initial consideration of \$4,674,400. The fair value of the common stock issued in connection with the ATN acquisition was determined by management with the assistance of an investment banking advisor of the Company and through negotiations with management of ATN.

\$3,511,025 was recorded as additional consideration in September 2006, to be issued as an estimated 183,000 shares of the Company's stock to stockholders of ATN as of the acquisition date. The additional consideration was calculated in accordance with the provisions of the purchase agreement as the amount equal to (a) the quotient obtained by dividing (i) revenue generated by the off-hours teleradiology business from ATN customers during the twelve month period ended September 30, 2006 by (ii) \$12.69 (which was the value per share of Company common stock on the date of completion of the acquisition (as agreed by the parties)) minus (b) 315,279 (which was the number of shares of Company common stock issued to the stockholders of ATN at the completion of the acquisition). The contingent consideration ultimately due is subject to agreement by the former stockholders and Company management.

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-K

additional shares of Company common stock that may be issued in an amount equal to the sum of (a) the quotient obtained by dividing (i) earnings before interest, taxes, depreciation and amortization, or EBITDA, generated by the hospital business during the twelve month period ending March 31, 2007 by (ii) \$12.69, which was the value per share of Company common stock on the date of completion of the acquisition (as agreed by the parties), plus (b) the quotient obtained by dividing (A) three times (3x) the EBITDA amount described in clause (i) by (B) the fair market value of Company common stock, determined on a per share basis, on March 31, 2007.

Table of Contents

The determination of the estimated fair value of the intangible assets acquired required management to make significant estimates and assumptions, including future expected cash flows from customer contracts and the value of customer lists and the ATN tradename including assumptions about the period of time such tradename will continue to be used by the Company.

The acquisition of ATN resulted in the assets acquired and liabilities assumed being recorded based on their estimated fair values on the acquisition date. Goodwill of \$3,959,056, representing the excess of the purchase price over the fair value of tangible and identifiable intangible assets acquired and liabilities assumed, will not be amortized, consistent with the guidance in SFAS No. 142. As part of the acquisition, the Company also assumed liabilities for employee relocation and employee termination costs. The results of operations of ATN have been included in the Company's consolidated statements of operations and cash flows starting on October 1, 2005.

The following table presents the allocation of the purchase price to the acquired assets and liabilities:

| | |
|-------------------------------|---------------------|
| Current assets | \$ 1,371,331 |
| Furniture and fixtures | 187,192 |
| Intangible assets | 2,680,000 |
| Goodwill | 3,959,056 |
| Assets acquired | 8,197,579 |
| Current liabilities assumed | 1,096,497 |
| Long-term liabilities assumed | 1,260,985 |
| Liabilities assumed | 2,357,482 |
| Net assets acquired | \$ 5,840,097 |

The amount allocated to intangible assets was attributed to the following categories:

| | Acquired Value | Estimated Useful Life |
|----------------------------------|---------------------|--------------------------|
| Customer lists and relationships | \$ 1,880,000 | 6 years |
| Tradename and trademarks | 640,000 | 10 years |
| Noncompete agreements | 160,000 | 3 years |
| | \$ 2,680,000 | |

All intangible assets are amortized on a straight-line basis over their expected useful lives (Note 5). The following unaudited pro forma information assumes the ATN acquisition occurred as of January 1, 2004. The unaudited pro forma financial information summarizes the results of operations for the years ended December 31, 2005 and 2004. The unaudited pro forma results are not necessarily indicative of what would have occurred had the acquisition actually been made as of January 1, 2004 or of future operations of the combined companies.

| | Year Ended | |
|-----------------|----------------------|------------------------------------|
| | December 31, 2005 | Year Ended December 31, 2004 |
| | (unaudited) | |
| Service revenue | \$ 67,265,213 | \$ 40,842,193 |

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-K

| | | |
|---|-----------------|--------------|
| Net income (loss) | \$ (29,842,708) | \$ 2,795,736 |
| Net income (loss) applicable to common shareholders | \$ (36,391,714) | \$ 2,030,994 |
| Earnings (loss) per common share, basic and diluted | \$ (2.08) | \$ 0.09 |

Table of Contents**4. MARKETABLE SECURITIES**

At December 31, 2006, marketable securities includes various available-for-sale securities. These securities are carried at fair value, with the unrealized gains and losses, net of taxes, reported as a component of stockholders' equity. Gross unrealized gains and losses on marketable securities were not significant at December 31, 2006.

Below are the Company's marketable securities as of December 31, 2006:

| | Fair Value |
|---|-------------------|
| Due in one year or less: | |
| U.S. Government and Federal Agency Securities | \$ 19,931,536 |
| Municipal Securities | 7,049,427 |
| Due after three years: | |
| Municipal Securities | 10,830,000 |
| Total Marketable Securities | \$ 37,810,963 |

5. INTANGIBLE ASSETS

The Company records intangible assets at historical cost. The Company amortizes its intangible assets using the straight-line method over their estimated useful lives. The Company reviews intangible assets subject to amortization quarterly to determine if any adverse conditions exist or a change in circumstances has occurred that would indicate impairment or a change in the remaining useful life. In addition, the Company reviews its indefinite-lived intangible assets at least annually for impairment and reassesses their classification as indefinite lived assets. As a result of the annual review, the Company identified that due to industry changes and changes in company directions, the Tradename with an indefinite life should be changed to a definite life. This change will result in higher amortization expense as reflected in the table below. The Company noted no impairments as part of the analysis.

A summary of intangible assets at December 31 is as follows:

| | Estimated Useful Life | 2006 | 2005 |
|---------------------------------------|----------------------------------|------------------|------------------|
| Amortized intangible assets: | | | |
| Customer lists and relationships | 6-10 years | \$ 2,620,000 | \$ 2,620,000 |
| Tradename and trademarks | 10 years | 790,000 | 150,000 |
| Customer contracts | 7 months | 100,000 | 100,000 |
| Noncompete agreements | 2-3 years | 210,000 | 210,000 |
| | | 3,720,000 | 3,080,000 |
| Accumulated amortization | | (797,457) | (288,582) |
| Total amortized intangible assets | | \$ 2,922,543 | \$ 2,791,418 |
| Unamortized intangible assets: | | | |
| Tradename and trademarks | | | 640,000 |
| Total intangible assets | | \$ 2,922,543 | \$ 3,431,418 |

Table of Contents

Amortization expense was approximately \$509,000, \$253,000 and \$36,000, for the years ended December 31, 2006, 2005 and 2004, respectively.

| Estimated Amortization Expense: | Amount |
|--|---------------------|
| Year ending December 31, 2007 | \$ 526,778 |
| Year ending December 31, 2008 | 513,444 |
| Year ending December 31, 2009 | 473,444 |
| Year ending December 31, 2010 | 473,444 |
| Year ending December 31, 2011 | 395,111 |
| Thereafter | 540,322 |
| Total | \$ 2,922,543 |

6. PROPERTY AND EQUIPMENT

Property and equipment consists of the following:

| | December 31, | |
|--|---------------------|---------------------|
| | 2006 | 2005 |
| Computers, diagnostic workstations, and telecommunications systems | \$ 4,353,715 | \$ 3,361,821 |
| Office furniture and equipment | 813,614 | 530,544 |
| Software | 3,162,586 | 1,803,112 |
| Leasehold improvements | 1,286,507 | 1,208,020 |
| | 9,616,422 | 6,903,497 |
| Less accumulated depreciation | (3,423,881) | (1,824,217) |
| | \$ 6,192,541 | \$ 5,079,280 |

Depreciation expense for the years ended December 31, 2006, 2005 and 2004 was approximately \$1,690,000, \$1,098,000 and \$492,000, respectively.

7. LONG-TERM DEBT

As of December 31, 2004, the Company had total notes payable of \$12,000,000. This balance was comprised of a \$3,000,000 revolving line of credit with Silicon Valley Bank (SVB) and \$9,000,000 of subordinated debt from the investment firm that also purchased the Company's redeemable convertible preferred stock (see Note 1). The \$3,000,000 line of credit was provided under a revolving credit facility with a total of \$3,500,000 in borrowing capacity. The committed revolving line included a letters-of-credit sublimit (see Note 8). Interest under this credit facility accrued at SVB's prime rate, which was 5.25% at December 31, 2004. The long-term debt was comprised of six different promissory notes to funds affiliated with the investment firm. Interest accrued at a rate of 10% per annum. Principal on the individual notes was due on March 10, 2010. The Company was required to pay the entire outstanding principal amount due on the notes and all accrued and unpaid interest upon the consummation of a prepayment event, as defined in the notes.

On April 20, 2005, the Company entered into a loan and security agreement with Comerica Bank. The agreement provided \$15,000,000 in senior secured credit facilities comprised of a \$12,000,000 term loan and a \$3,000,000 revolving line of credit loan. The \$12,000,000 term loan was used to repay the \$9,000,000 in long-term debt outstanding at December 31, 2004 and the \$3,000,000 outstanding under the credit facility with SVB.

In August 2005, the Company executed an amendment to its loan and security agreement with Comerica Bank to increase the Company's term loan facility by an additional \$20,000,000 from an aggregate of \$12,000,000 to \$32,000,000. Interest under the facility was computed based, at the Company's option, on Comerica's prime rate, or certain LIBOR rates, plus a margin.

Table of Contents

The additional \$20,000,000 in available funding was comprised of two separate term loans: 1) \$13,000,000 was combined with the previous \$12,000,000 to form Term Loan A and 2) another \$7,000,000 was available (Term Loan B) for borrowing prior to February 28, 2006. The purpose of this additional \$20,000,000 was to fund two special dividends declared by the Company's Board of Directors in September 2005 (see Note 13).

In September 2005, the Company borrowed the \$13,000,000 to fund the first special dividend. The effective interest rate on this term loan was accrued at 7.25% at December 31, 2005 based on the lender's prime rate. As a result of this borrowing, the outstanding balance of Term Loan A as of December 31, 2005 was approximately \$24,000,000.

As a result of the ATN acquisition in September 2005, the Company assumed two lines of credit. Both lines of credit were repaid and terminated in November 2005.

On February 9, 2006, the Company borrowed an additional \$7,000,000 under its term loan facility with Comerica Bank and distributed the full amount as a special dividend to the holders of its common stock and its then-outstanding redeemable convertible preferred stock. See Dividends discussion in Note 13. On January 2, 2006, the Company paid a regularly scheduled debt payment to Comerica in the amount of approximately \$1,100,000. On February 14, 2006, the Company repaid in full the debt and interest outstanding with Comerica Bank in the amount of approximately \$30,100,000 with proceeds from the Company's initial public offering. Subsequent to repaying this outstanding debt, the Company terminated its term and revolving loan facilities with Comerica Bank in the first quarter of 2006.

8. COMMITMENTS AND CONTINGENCIES

Leases The Company has operating leases with varying periods for offices around the world. Total rent expense was approximately \$1,141,000, \$793,000 and \$457,000 for the years ended December 31, 2006, 2005 and 2004, respectively.

The following is a schedule of approximate future minimum lease payments under operating leases as of December 31, 2006:

| | |
|------------|---------------------|
| 2007 | \$ 1,297,809 |
| 2008 | 1,353,662 |
| 2009 | 810,396 |
| 2010 | 742,513 |
| 2011 | 588,248 |
| Thereafter | 2,229,885 |
| | \$ 7,022,513 |

In January 2007, the Company signed a lease for a new reading facility in San Francisco, California. The lease expires in 2012 and resulted in an additional total lease commitment of approximately \$1,268,000.

Letters of Credit The Company's Sydney office lease and the Company's malpractice insurance are collateralized by separate letters of credit in the amounts of approximately \$173,000 and \$400,000, respectively, as of December 31, 2006 and approximately \$163,000 and \$300,000, respectively, as of December 31, 2005.

Litigation The Company is involved in litigation in the normal course of business. After consultation with legal counsel, management estimates that at December 31, 2006 and 2005 these matters are expected to be resolved without material adverse effect on the Company's financial position, results of operations, or cash flows.

Table of Contents

Medical Liability Insurance The Company is exposed to various risks of loss related to litigation that may arise related to malpractice and maintains insurance for medical liabilities in amounts considered adequate by Company management. The Company's claims-made policy provides coverage up to the policy limits for claims filed within the period of the policy term, subject to deductible requirements. Coverage for affiliated radiologists is initiated when they begin providing services on behalf of the Company.

The Company records reserves for both reported and incurred but not reported (IBNR) amounts. Reported amounts are reserved based upon the Company's best estimate of future probable costs and totaled \$700,000 and \$100,000 at December 31, 2006 and 2005, respectively. IBNR claims are actuarially estimated by a third party using historical claims lag information received by our third party claims administrator and industry indices. Due to the uncertainty of health claims, the shortness of claim history and the young age of the teleradiology industry, the Company had not been able to estimate this cost in prior years. As of December 31, 2006, the Company was able to have an actuarial study performed and as a result, the Company recorded a \$2,000,000 (pre-tax) reserve for these potential liabilities based on this analysis. This reserve is intended to cover potential medical claims that might arise related to all of the radiological interpretations performed by the Company's doctors since inception.

9. RELATED PARTY TRANSACTIONS

During 2004, a stockholder of the Company who is also an officer of the Company, provided radiology services to the Company. In addition to salary, the Company paid approximately \$65,000 for his radiology services. No services were provided during the years ended December 31, 2006 or 2005.

The Company provided radiology services to a former member of Nighthawk Radiology Services, LLC without charge. The former member provides radiology readings to a local hospital during business hours and the Company provided off-hours and emergency radiology readings to a local hospital on the member's behalf. The estimated value of the services provided by the Company, based on rates charged to unrelated third parties for 2006, 2005 and 2004, was approximately \$110,000, \$110,000 and \$113,000, respectively. These services are included in service revenue and professional fees.

During the year ended December 31, 2004, the Company entered into a debt transaction for \$12,000,000 with its preferred stockholder (see Note 7). The Company incurred approximately \$271,000 and \$850,000 of interest related to this debt in 2005 and 2004, respectively. The debt was refinanced in April 2005 with a commercial bank.

On May 28, 2004, the Company issued 638,876 shares of restricted common stock to a person who subsequently became a non-employee member of the Company's Board of Directors. These shares have been recorded in accordance with EITF No. 96-18. In 2004, the Company recognized non-cash stock compensation expense of approximately \$100,000. On June 9, 2005, the Company's Board of Directors accelerated vesting of these shares and as a result, the Company recognized non-cash stock compensation expense of approximately \$2,900,000.

In November 2004, the Company issued 1,007,500 shares of common stock to a related party who had previously been granted a warrant to purchase units in the LLC in 2003. These warrants were accounted for in accordance with EITF No. 96-18 and resulted in non-cash stock compensation of approximately \$1,500,000 in 2004.

10. STOCK COMPENSATION PLANS

Adoption of SFAS 123(R). Effective January 1, 2006, the Company adopted the provisions of SFAS No. 123(R) for its stock-based compensation plans. SFAS No. 123(R) requires the measurement and recognition of compensation expense for all stock-based awards made to employees and directors based on estimated fair values. SFAS No. 123(R) supersedes APB 25. In March 2005, the SEC issued Staff Accounting Bulletin 107 (SAB 107) relating to SFAS No. 123(R). The Company has applied the provisions of SAB 107 in the adoption of SFAS No. 123(R).

Table of Contents

The Company previously accounted for these plans under the recognition and measurement principals and disclosure requirements established by SFAS No. 123, as amended by SFAS No. 148. Under SFAS No. 123, compensation expense was recorded in operations for the Company's stock-based awards granted under the 2004 plan, so compensation expense related to all the Company's stock-based compensation plans have been recorded in both the current and prior year comparative periods.

The Company adopted SFAS 123(R) using the modified prospective method, which requires the application of the accounting standard as of January 1, 2006, the first day of fiscal year 2006. The financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS No. 123(R).

Share Based Award Plans. The Company has two stock-based award plans, the 2004 Stock Plan (the 2004 Plan) and the 2006 Equity Incentive Plan (the 2006 Plan).

The 2004 Stock Plan was adopted by the Board of Directors and authorizes the grant or issuance of options and other awards including a repurchase option. When initially adopted, the Plan allowed for a maximum number of shares of 1,221,805 shares, subject to adjustment for stock splits, stock dividends and similar events. In March 2005, the Board of Directors increased the option pool by 320,000 shares, an additional 120,000 shares in September 2005, and 120,000 shares in November 2005 bringing the total authorized number of option shares to 1,781,805 as of December 31, 2005. The shares may be authorized but unissued or reacquired common stock.

On February 14, 2006, the 2006 Plan became effective, with a total of 1,600,000 shares of our common stock initially authorized for issuance thereunder. In addition, shares available for grant under the 2004 Plan as of such date were rolled over and became available for grant under the 2006 Plan, as will shares subject to options that expire or are cancelled or forfeited under the 2004 Plan. In addition, on the first day of each fiscal year beginning in 2007, the number of shares available for issuance under the 2006 Plan may be increased by an amount equal to the lesser of (i) 3% of the outstanding shares of our common stock on the first day of the fiscal year, and (ii) such other amount as our board of directors may determine. At December 31, 2006, the Company had 1,528,392 stock-based awards available to be issued under its 2006 Plan.

The Board of Directors administers the Plan and establishes to whom the awards are granted, and the terms and conditions, including the exercise period, of such awards. All stock options granted have an exercise price equal to or greater than the fair value of our common stock on the date the option is granted. Stock options granted generally have a contractual term of ten years and vest over three years. The Company recognizes compensation cost for employee options on a straight-line basis over the service period for the entire award.

Non-Employee Grants. The Company records stock-based compensation expense in connection with any grant of stock options, restricted stock units, or other issuance of shares of common stock to our affiliated radiologists. Stock-based compensation expense associated with the issuance of stock options to our affiliated radiologists is calculated in accordance with SFAS No. 123 (R) and EITF No. 96-18, by determining the fair value using a Black-Scholes model.

In accordance with EITF No. 96-18, because our radiologists are treated as independent contractors and not as employees, we calculate the fair value of the stock-based compensation expense in each period. The expense amount is determined by calculating the fair value of the shares earned in each period and recording that amount as expense during such period. If the price of our common stock increases over a given period, this accounting treatment results in compensation expense that exceeds the expense we would have recorded if these individuals were employees. Stock-based compensation to our affiliated radiologists is included in professional services expense.

Table of Contents

A summary of our stock-based award activity for employees and non-employees under the 2004 and 2006 plans are as follows:

| | Number of | Weighted | Weighted Average | Aggregate |
|---|---------------|------------------|------------------------|-----------------|
| Stock Options | Stock Options | Average Exercise | Remaining | Intrinsic Value |
| | | Price | Contractual Life (Yrs) | |
| Outstanding as of January 1, 2006 | 1,723,590 | \$ 3.47 | | |
| Granted | 170,320 | 15.17 | | |
| Exercised | (134,498) | 3.00 | | |
| Cancelled | (79,849) | 6.01 | | |
| Outstanding as of December 31, 2006 | 1,679,563 | \$ 4.58 | 8.17 | \$ 35,144,000 |
| Exercisable as of December 31, 2006 | 380,344 | \$ 2.98 | 8.04 | \$ 8,567,000 |
| Vested and expected to vest as of December 31, 2006 | 1,334,418 | \$ 4.50 | 8.17 | \$ 28,020,000 |

Intrinsic value represents the amount by which the fair market value of the underlying stock exceeds the exercise price of the options. The weighted-average grant date fair value of stock options granted, the total intrinsic value of options exercised and the fair value of shares that have vested during each of the past three years is as follows:

| | Fiscal Years Ended December 31, | | |
|--|---------------------------------|------------|---------|
| | 2006 | 2005 | 2004 |
| Weighted-average grant date fair value | \$ 8.39 | \$ 2.43 | \$ 0.99 |
| Intrinsic value of exercised options | \$ 2,180,000 | | |
| Fair value of shares vested | \$ 407,000 | \$ 150,000 | \$ |

During the year ended December 31, 2006, options to purchase 134,498 shares of common stock were exercised for proceeds of approximately \$404,000. There were no exercises in 2005 or 2004.

A reconciliation of the non-vested options as of December 31, 2006, and changes during the fiscal year then ended is as follows:

| Outstanding Non-Vested Stock Options | Number of | Weighted Average |
|--------------------------------------|---------------|-----------------------|
| | Stock Options | Grant Date Fair Value |
| Outstanding as of January 1, 2006 | 1,532,912 | \$ 1.70 |
| Granted | 170,320 | 8.39 |
| Vested | (324,164) | 1.26 |
| Cancelled | (79,849) | 2.65 |
| Outstanding as of December 31, 2006 | 1,299,219 | \$ 2.63 |

During the year ended December 31, 2006, the Company utilized restricted stock unit awards for the first time. Activity related to these restricted stock unit awards is as follows:

| Restricted Stock Unit Awards | Number of | Weighted | Weighted Average | Aggregate |
|------------------------------|-----------|--------------------|------------------|-----------------|
| | Awards | Average Fair Value | Remaining | Intrinsic Value |

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-K

| | | | Contractual Life (Yrs) | |
|-------------------------------------|---------|----|------------------------|-------------------|
| Outstanding as of January 1, 2006 | | | | |
| Granted | 97,272 | \$ | 20.15 | |
| Exercised | | | | |
| Cancelled | (1,920) | | 19.88 | |
| Outstanding as of December 31, 2006 | 95,352 | \$ | 20.16 | 2.06 \$ 2,431,000 |
| Exercisable as of December 31, 2006 | | | | |
| Vested and expected to vest as of | | | | |
| December 31, 2006 | 74,405 | \$ | 20.16 | 1.95 \$ 1,897,000 |

Table of Contents

As of December 31, 2006, total remaining unrecognized compensation cost related to unvested stock-based employee/director arrangements was approximately \$1,100,000 and is expected to be recognized over a weighted average period of 0.9 years.

Recognition of compensation expense. Stock-based compensation expense, along with the related income tax benefit, for each of the past three years was approximately as follows:

| | Fiscal Years Ended December 31, | | |
|---|---------------------------------|--------------|--------------|
| | 2006 | 2005 | 2004 |
| Stock-based compensation expense recognized | \$ 5,960,000 | \$ 4,189,000 | \$ 1,690,000 |
| Income tax benefit recognized | (2,316,000) | (1,626,000) | (658,000) |
| After-tax stock-based compensation expense | \$ 3,644,000 | \$ 2,563,000 | \$ 1,032,000 |

We measure the compensation cost associated with stock-based payments by estimating the fair value of stock options as of the grant date using the Black-Scholes option pricing model. The Company believes that the valuation technique and the approach utilized to develop the underlying assumptions are appropriate in calculating the fair values of the stock options granted. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by the employees who receive equity awards.

The assumptions used to estimate the fair value of the stock-based arrangements were as follows:

| | Year Ended December 31, 2006 | Year Ended December 31, 2005 | Year Ended December 31, 2004 |
|--|---------------------------------|---------------------------------|---------------------------------|
| Dividend yield | | | |
| Expected volatility | 39% | 39% | 54% |
| Risk-free interest rates | 4.84% | 4.10% | 3.25% |
| Expected term for employees (years) | 4.7 | 3.0 | 3.0 |
| Expected/remaining term for non-employee (years) | 10 | 10 | 10 |

Expected volatility is estimated based on evaluating similar companies' volatility rates, due to the Company's limited trading history. The Company anticipates incorporating its history into the estimates as it becomes available. The risk-free interest rate is based on the U.S. treasury yields in effect at the time of grant corresponding with the expected term of the options. The expected option term for employees is the number of years estimated that options will be outstanding prior to exercise considering vesting schedules, historical exercise experience and factors.

Table of Contents**11. EARNINGS PER SHARE**

The following table presents a reconciliation of the numerators and denominators used in the basic and diluted earnings per common share computations:

| | Fiscal Years Ended December 31, | | |
|---|---------------------------------|-----------------|--------------|
| | 2006 | 2005 | 2004 |
| Numerator: | | | |
| Net income (loss) available in basic calculation | \$ (28,518,651) | \$ (36,509,398) | \$ 2,560,497 |
| Plus: Income impact of assumed conversions of preferred stock dividends | (a) | (a) | (a) |
| Income (loss) available to common stockholders plus assumed conversions | \$ (28,518,651) | \$ (36,509,398) | \$ 2,560,497 |
| Denominator: | | | |
| Weighted-average common shares outstanding basic | 28,528,079 | 17,273,970 | 24,196,437 |
| Effect of dilutive stock options and restricted stock units | (b) | (b) | (b) |
| Effect of convertible preferred stock | (a) | (a) | (a) |
| Effect of contingently issuable shares | (c) | | |
| Weighted average common shares outstanding dilutive | 28,528,079 | 17,273,970 | 24,196,437 |
| Earnings (loss) per common share basic and diluted | \$ (1.00) | \$ (2.11) | \$ 0.11 |

- (a) The income impact of assumed conversions of the preferred stock dividends and the effect of the convertible preferred stock in the denominator are anti-dilutive.
- (b) The effects of the shares which would be issued upon exercise of these options and restricted stock units have been excluded from the calculation of diluted earnings (loss) per common share because they are anti-dilutive.
- (c) The effects of the shares which would be issued upon finalization of our ATN purchase have been excluded from the calculation of diluted earnings (loss) per common share because they are anti-dilutive.

12. INCOME TAXES

Until March 2004, the Company operated as NightHawk Radiology Services, LLC, an Idaho limited liability company (the "LLC"). The Company was recapitalized in March 2004 and NightHawk Radiology Holdings, Inc. was formed for the purpose of acquiring all of the outstanding units of the LLC and all of the outstanding shares of NRS Corporation, whose only assets were outstanding units of the LLC. The income tax effect of operations prior to March 31, 2004 is not reported in the financial statements of the Company because such operations were conducted through a limited liability company whereby such income tax obligations were the responsibility of the LLC's members. As a result of the recapitalization on March 31, 2004 (see Note 1), the Company received approximately \$514,000 from former shareholders of NRS Corporation for its portion of the income tax effect of operations through March 31, 2004. In accordance with SFAS No. 109, *Accounting for Income Taxes*, deferred tax assets and liabilities are recognized for temporary differences at the recapitalization date and the income tax effect of recognizing these deferred items was \$291,533 and is included in income tax expense for the period March 31, 2004 to December 31, 2004.

On September 30, 2005, NightHawk Radiology Holdings, Inc. acquired American Teleradiology Nighthawks, Inc. a corporation organized under the laws of the State of Delaware. The acquisition was a merger within the meaning of Section 368(a) of the Internal Revenue Code of 1986, as amended. In accordance with SFAS No. 109, *Accounting for Income Taxes*, deferred assets and liabilities are recognized for temporary differences between the assigned values and the tax bases of the assets and liabilities recognized in a business combination. The effect of recognizing these deferred items was a net deferred tax liability of \$1,228,206 and is included in the business combination at September 30, 2005.

Table of Contents

Deferred income taxes are recognized for temporary differences between the financial statements and tax basis of assets and liabilities using presently enacted tax rates and laws.

Deferred tax assets and liabilities consist of the following:

| | December 31, | |
|--|------------------|------------------|
| | 2006 | 2005 |
| Deferred tax assets: | | |
| Accrued compensation and employee benefits | \$ 3,080,880 | \$ 790,102 |
| Malpractice claims reserve | 1,050,890 | 38,811 |
| Allowance for doubtful accounts | 157,476 | 120,967 |
| Deferred rent | 59,567 | 75,054 |
| Other, net | 12,125 | 29,109 |
| Total deferred tax assets | 4,360,938 | 1,054,043 |
| Deferred tax liabilities: | | |
| Basis difference in intangible assets | 566,514 | 696,752 |
| Basis difference in property and equipment | 473,765 | 265,614 |
| Effect of change from cash to accrual accounting for tax | 337,998 | 702,141 |
| Prepaid expenses | 135,759 | |
| Total deferred tax liabilities | 1,514,036 | 1,664,507 |
| Net deferred tax assets (liabilities) | \$ 2,846,902 | \$ (610,464) |

For the years ended December 31, 2006 and 2005, income considered to be permanently reinvested in non-U.S. subsidiaries totaled approximately \$187,000 and \$83,000, respectively. Deferred U.S. income taxes have not been provided on this income, as the Company does not plan to initiate any action that would require the payment of U.S. income. It is not practical to estimate the amount of additional tax that might be payable on this undistributed foreign income.

Income tax expense consists of the following:

| | Fiscal Years Ended December 31, | | |
|------------------------------|---------------------------------|------------------|------------------|
| | 2006 | 2005 | 2004 |
| Current: | | | |
| Federal | \$ 11,181,582 | \$ 5,804,458 | \$ 2,721,537 |
| State | 2,048,848 | 1,077,603 | 548,772 |
| Foreign | 235,689 | 281,163 | 238,074 |
| Total current | 13,466,119 | 7,163,224 | 3,508,383 |
| Deferred: | | | |
| Federal | (3,073,961) | (696,118) | 138,870 |
| State | (344,445) | (75,804) | 15,310 |
| Total deferred | (3,418,406) | (771,922) | 154,180 |
| Total income tax expense | \$ 10,047,713 | \$ 6,391,302 | \$ 3,662,563 |

Table of Contents

The reconciliation between the federal statutory tax rate and the Company's effective tax rate is as follows:

| | Year Ended December 31, 2006 | | Year Ended December 31, 2005 | | Year Ended December 31, 2004 | |
|--|------------------------------------|---------|------------------------------------|---------|------------------------------------|---------|
| Computed federal income tax expense (benefit) at the statutory rate | \$ (6,423,675) | 35.0% | \$ (8,249,182) | 35.0% | \$ 2,375,850 | 34.0% |
| State income taxes, net of federal income tax benefit | 987,307 | (5.4)% | 624,638 | (2.6)% | 273,950 | 3.9% |
| Net deferred tax liability recorded at March 31, 2004 | | | | | 291,533 | 4.2% |
| Excluded LLC operations (pre-March 31, 2004) | | | | | (717,471) | (10.3)% |
| Change in fair market value of redeemable preferred stock conversion feature | 15,464,320 | (84.2)% | 13,904,966 | (59.0)% | 1,311,550 | 18.8% |
| Other, net | 19,761 | (0.1)% | 110,880 | (0.5)% | 127,151 | 1.8% |
| | \$ 10,047,713 | (54.7)% | \$ 6,391,302 | (27.1)% | \$ 3,662,563 | 52.4% |

13. STOCKHOLDERS EQUITY AND MEMBERS EQUITY

On January 23, 2006, the Company completed a reverse stock split, 1 for 1.25, of its common and preferred stock and correspondingly adjusted the number of options issued and available for issuance under the 2004 Plan. All numbers of common stock, preferred stock and per share data in the accompanying consolidated financial statements and related notes have been retroactively restated to give effect to the reverse stock split and the changes to the 2004 Plan.

On February 9, 2006, the Company completed an initial public offering (IPO) of 5,800,000 shares of its common stock, from which the Company received net proceeds of approximately \$86,300,000 (after deducting the underwriting discounts and commissions). The Company had incurred approximately \$2,100,000 in stock issuance costs. Subsequent to the IPO, these costs were charged against additional paid in capital on the consolidated balance sheet. In addition, at the closing of the IPO, all outstanding shares of the Company's redeemable convertible preferred stock converted into common stock and, as a result, the Company did not record any additional charge associated with the change in fair value of the conversion feature of the redeemable convertible preferred stock after such date. Prior to the IPO, this redeemable convertible preferred stock was classified as mezzanine equity on the consolidated balance sheet and the fair value of the related conversion feature was classified as a liability on the consolidated balance sheet. Also as a result of the conversion of all outstanding shares of redeemable convertible preferred stock into shares of common stock, all rights of the holders of such shares to receive accrued dividends or to exercise redemption rights terminated. As a result, the accretion relating to the Company's redeemable convertible preferred stock also terminated.

Finally, as a result of the Company's IPO, the rights of certain holders of our common stock to have their shares redeemed by the Company terminated. Prior to the IPO, this redeemable common stock was classified as mezzanine equity on the consolidated balance sheet and we recorded periodic accretions of the redemption value of such shares at each balance sheet date. Because this redemption right expired upon the IPO, the Company will no longer be recording the periodic accretions related to these redemption rights, and these shares of common stock will no longer be recorded as mezzanine equity on the consolidated balance sheet but, instead, as shares of common stock within shareholders' equity.

Preferred Stock At December 31, 2005, the Company had authorized and issued 6,500,003 shares of Series A redeemable, convertible preferred stock with a par value of \$0.001 per share. The holders of the preferred stock had the right but not the obligation to participate proportionately in certain types of future financings. Significant terms of this preferred stock were as follows:

Each share had the same voting rights as the number of common shares into which it was convertible. In addition, the holders of the Series A preferred had the right, voting separately from other

Table of Contents

stockholders, to elect one of five members of the Company's Board of Directors (three of the remaining members are elected separately by the common stockholders and the last member is elected by both the common and preferred stockholders).

Dividends were cumulative and accrued on a daily basis at the rate of 6% per annum beginning on the date of issuance and based on the sum of the liquidation value (\$2.00 per share) plus all accumulated and unpaid dividends. Dividends became accumulated at the end of each calendar quarter. Accumulated, accrued and unpaid dividends at December 31, 2005 were approximately \$1,430,000 (\$.22 per share).

Upon any liquidation, dissolution or winding up of the Company, the preferred stockholders were entitled to a liquidation preference payment equal to the greater of (i) the sum of the liquidation value (\$2.00 per share) plus all accumulated, accrued and unpaid dividends and (ii) the amount such holder would have been entitled to receive had such holder's shares been converted into common stock immediately prior to the liquidation, dissolution or winding up. At December 31, 2005, the liquidation value plus accumulated, accrued and unpaid dividends was approximately \$14,400,000.

Each share was convertible, at the option of the holder, into one share of common stock (subject to adjustments for events of dilution). In addition, the Company could require the conversion of all preferred shares upon the approval of a majority of the preferred stockholders or upon the completion of a public offering of common shares underwritten by a nationally recognized investment bank yielding proceeds of at least \$50,000,000 and a price of at least 4.3 times \$2.00 per share (subject to adjustments for events of dilution) (a Qualified Public Offering).

Upon conversion, each holder of preferred stock was also entitled to receive payment of all accumulated, accrued and unpaid dividends on the preferred stock unless such conversion was made in connection with a public offering of the Company's common stock.

In the event of a sale of more than 50% of the Company's assets or certain changes in ownership of the Company's stock as defined in the Company's Amended and Restated Certificate of Incorporation, and upon the consent of the holders of a majority of the preferred stock, each holder of preferred stock could require the Company to redeem all or a portion of such shares. The redemption price was equal to the liquidation value (\$2.00 per share) plus all accumulated, accrued and unpaid dividends.

At any time subsequent to March 31, 2011, the holders of a majority of the preferred shares could require the Company to redeem all or any portion of the preferred shares. The price paid by the Company to redeem the shares would be the greater of (i) the liquidation value (\$2.00 per share) plus all accumulated, accrued and unpaid dividends, and (ii) the market value of the common stock issuable upon conversion of the preferred shares. This redemption right expired upon completion of a Qualified Public Offering.

The Series A preferred stock provided the holders the right to require the Company to redeem such shares for cash after the seventh anniversary of the issuance of the Series A preferred shares. The Company would be required to redeem the Series A preferred shares at the greater of (a) its liquidation value plus any accrued but unpaid dividends or (b) the fair value of the common shares into which the Series A preferred shares are convertible. Therefore, the embedded conversion feature required separate accounting under SFAS No. 133. Consequently, the conversion feature was bifurcated from the preferred stock and accounted for separately. The carrying value of the embedded derivative was adjusted to fair value at the end of each reporting period and the change in fair value was recognized in the statement of operations. On the date of issuance, the estimated fair value of the conversion feature was approximately \$1,700,000 which was recorded as a liability on the date of issue thus reducing the recorded value of the redeemable convertible preferred stock to approximately \$11,300,000. At each balance sheet date, the Company adjusted the carrying value of the embedded derivative to the estimated fair value and recognized the change in such estimated value in the consolidated statements of operations. The estimated fair value at December 31, 2005 was approximately \$45,300,000.

Table of Contents

The Company also classified the redeemable convertible preferred stock as mezzanine equity on the consolidated balance sheet. As such, the Company accreted the carrying value of such stock to its redemption value using the effective interest method through the redemption period. Total accreted value at December 31, 2005 was approximately \$13,200,000, respectively.

Upon conversion of the redeemable preferred stock into common shares on the IPO date, the related embedded derivative was terminated. At termination date, the embedded derivative had an estimated fair value of approximately \$89,400,000, and this amount was subsequently reclassified from the liabilities section of the balance sheet to additional paid-in-capital.

Redeemable Common Stock At any time subsequent to March 31, 2006, three of the Company's common stockholders who are also executives of the Company could require the Company to repurchase up to 1,671,429 shares of common stock. The repurchase price was the estimated market value of the common stock at the date of repurchase. Each of the stockholders could require a redemption one time only. This redeemable common stock was classified as mezzanine equity on the consolidated balance sheet and periodic accretions were recorded such that the recorded value was equal to the redemption value at each balance sheet date. This redemption right expired upon completion of the IPO. On the date of issuance, March 31, 2004, the estimated fair value of the redeemable common stock was approximately \$1,300,000 which was recorded as mezzanine equity. The Company accreted the carrying value of such stock to its redemption value for each reporting period. Total accreted value at December 31, 2005 was approximately \$15,400,000.

Dividends In September 2005, the Company's Board of Directors declared two special dividends. The first dividend was \$13,000,000 or \$0.549 per share for each share of common stock and preferred stock outstanding as of September 9, 2005, the record date. This dividend was distributed to the Company's stockholders in September 2005 and was funded by a term loan facility from Comerica Bank (see Note 7). The second dividend was paid on February 9, 2006, when the Company borrowed an additional \$7,000,000 under its term loan facility and distributed the full amount as a special dividend to the holders of common stock and then-outstanding redeemable convertible preferred stock.

There were no dividends declared in 2006 or 2004.

14. SUBSEQUENT EVENT

On February 9, 2007, The Company entered into a Share Purchase Agreement with Teleradiology Diagnostic Service, Inc. (TDS), each of the shareholders of TDS and certain other related parties, pursuant to which the Company acquired all of the outstanding stock of TDS. The execution of the Share Purchase Agreement and the closing of the transaction occurred simultaneously. Under the terms of the Share Purchase Agreement, the Company acquired all of the outstanding stock of TDS, a privately held company, for an aggregate consideration of \$23,000,000 in cash.

Table of Contents

ITEM 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

During the fiscal years ended December 31, 2006 and 2005, there were no changes in, or disagreements with, accountants on accounting and financial disclosure matters.

ITEM 9A. Controls and Procedures

Disclosure Controls and Procedures

Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Annual Report on Form 10-K. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is accumulated and communicated to our management, including our principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure, and that such information is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

This annual report does not include a report of management's assessment regarding internal control over financial reporting or an attestation report of the Company's registered public accounting firm due to a transition period established by rules of the Securities and Exchange Commission for newly public companies.

ITEM 9B. Other Information

None.

Table of Contents**PART III****ITEM 10. Directors, Executive Officers and Corporate Governance of the Registrant**

Information required by Item 10 of Part III is included in our Proxy Statement relating to our 2007 Annual Meeting of Shareholders and is incorporated herein by reference.

ITEM 11. Executive Compensation

Information required by Item 11 of Part III is included in our Proxy Statement relating to our 2007 Annual Meeting of Shareholders and is incorporated herein by reference.

ITEM 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Information required by Item 12 of Part III is included in our Proxy Statement relating to our 2007 Annual Meeting of Shareholders and is incorporated herein by reference.

Securities Authorized for Issuance Under Equity Compensation Plans

The following table sets forth information about our equity compensation plans as of December 31, 2006:

| Plan category | (a) Number of securities to be issued upon exercise of outstanding options, warrants and rights | (b) Weighted-average exercise price of outstanding options, warrants and rights (2) | (c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities) |
|---|---|---|---|
| Equity compensation plans approved by security holders | 157,704 | \$ 23.05 | 1,528,392 |
| Equity compensation plans not approved by security holders (1) | 1,617,211 | 3.86 | 0 |
| Total | 1,774,915 | \$ 4.58 | 1,528,392 |

- (1) The 2004 Stock Plan permits only grants of Nonstatutory Stock Options and therefore did not require stockholder approval. We did obtain the requisite consent from certain stockholders for the adoption of the 2004 Stock Plan pursuant to a contractual obligation.
- (2) The weighted-average exercise price does not take in to account the shares issuable upon vesting of outstanding restricted stock unit awards, which have no exercise price.

ITEM 13. Certain Relationships and Related Transactions and Director Independence

Information required by Item 13 of Part III is included in our Proxy Statement relating to our 2007 Annual Meeting of Shareholders and is incorporated herein by reference.

ITEM 14. Principal Accounting Fees and Services

Information required by Item 14 of Part III is included in our Proxy Statement relating to our 2007 Annual Meeting of Shareholders and is incorporated herein by reference.

Table of Contents

PART IV

ITEM 15. Exhibits, Financial Statement Schedules

(a) The following documents are filed as part of this report:

- 1) Consolidated Financial Statements: See Index to Consolidated Financial Statements at Item 8 on page 58 of this report.
- 2) Financial Statement Schedule: Schedule II Consolidated Valuation and Qualifying Accounts
- 3) Exhibits are incorporated herein by reference or are filed with this report as set forth below:

Table of Contents**NightHawk Radiology Holdings, Inc.****SCHEDULE II CONSOLIDATED VALUATION AND QUALIFYING ACCOUNTS**

| | Balance at Beginning of Period | Charged (Credited) to Costs and Expenses | Deductions/ Write-offs | Balance at End of Period |
|--|---|---|-----------------------------------|-------------------------------------|
| <i>Allowance for Doubtful Accounts</i> | | | | |
| Year ended December 31, 2004 | \$ 0 | \$ 0 | \$ 0 | \$ 0 |
| Year ended December 31, 2005 | 0 | 311,681 | 0 | 311,681 |
| Year ended December 31, 2006 | 311,681 | 468,407 | 400,493 | 379,595 |

| | Balance at Beginning of Period | Charged (Credited) to Costs and Expenses | Deductions/ Write-offs | Balance at End of Period |
|------------------------------------|---|---|-----------------------------------|-------------------------------------|
| <i>Allowance for Sales Credits</i> | | | | |
| Year ended December 31, 2004 | \$ 0 | \$ 0 | \$ 0 | \$ 0 |
| Year ended December 31, 2005 | 0 | 40,000 | 0 | 40,000 |
| Year ended December 31, 2006 | 40,000 | 0 | 15,000 | 25,000 |

Table of Contents

| Exhibit | |
|----------------|--|
| Number | Description |
| 3.1(1) | Form of Amended and Restated Certificate of Incorporation of the registrant. |
| 3.2(1) | Form of Amended and Restated Bylaws of the registrant. |
| 4.1(2) | Form of registrant's common stock certificate. |
| 4.2(1) | Registration Agreement, dated March 31, 2004, between the registrant and certain holders of the registrant's common stock as named therein. |
| 10.1(1) | Form of Indemnification Agreement to be entered into between the registrant and its directors and officers. |
| 10.2(1)* | 2004 Stock Plan. |
| 10.3(1)* | Form of Stock Option Agreement under the 2004 Stock Plan. |
| 10.4(3)* | 2006 Equity Incentive Plan. |
| 10.5(3)* | Form of Stock Option Agreement under the 2006 Equity Incentive Plan. |
| 10.6(1)* | Employment Agreement, dated March 30, 2004, between the registrant and Paul E. Berger, M.D. |
| 10.7(1)* | Offer Letter with Christopher R. Huber, dated March 31, 2004. |
| 10.8(1)* | Offer Letter with Jon D. Berger, dated March 31, 2004. |
| 10.9(1)* | Professional Services Agreement, dated February 1, 2004, between Nighthawk Radiology Services, LLC and Paul E. Berger, M.D. |
| 10.10(1)* | Consulting Agreement, dated June 9, 2004, between the registrant and William G. Bradley, M.D. |
| 10.11(1) | Loan and Security Agreement, dated April 20, 2005, among the registrant, Nighthawk Radiology Services, LLC, NRS Corporation and Comerica Bank. |
| 10.12(1) | First Amendment and Waiver to Loan and Security Agreement, dated August 25, 2005, among the registrant, Nighthawk Radiology Services, LLC, NRS Corporation and Comerica Bank. |
| 10.13(1) | Lease Agreement, dated May 1, 2005, between Nighthawk Radiology Services, LLC and Global Finance & Investment Co., Inc. for property in Coeur d'Alene, Idaho. |
| 10.13.1(4) | Lease Amendment, dated December 1, 2005, between Nighthawk Radiology Services, LLC and Global Finance & Investment Co., for property in Coeur d'Alene, Idaho. |
| 10.14(1) | Lease Agreement, dated August 11, 2004, among the registrant, Stanley D. Moore and Judith K. Moore for property in Coeur d'Alene, Idaho. |
| 10.15(1) | Sublease Agreement, dated October 14, 2003, among Nighthawk Radiology Services, LLC, Commonwealth Funds Management Limited and BT Funds Management Limited for property in Sydney, Australia. |
| 10.16(1) | Sublease Agreement, dated October 1, 2004, among Nighthawk Radiology Services, LLC, Commonwealth Custodial Services Limited, Commonwealth Funds Management Limited and Investa Properties Limited for property in Sydney, Australia. |
| 10.17(1) | Lease Agreement, dated September 1, 2004, between NightHawk Radiology AG and PSP Real Estate for property in Zurich, Switzerland. |
| 10.18(1) | Lease Agreement, dated February 25, 2004, between Nighthawk Radiology Services, LLC and Demco Wisconsin 5 for property in Milwaukee, Wisconsin. |
| 10.19(1) | Agreement and Plan of Merger and Reorganization, dated September 30, 2005, among the registrant, ATN Merger Sub, Inc. and American Teleradiology Nighthawks, Inc. |
| 10.20(5) | Lease Agreement, dated October 18, 2005, between Nighthawk Radiology Services, LLC and Miller Stauffer Properties, L.L.C. for property in Coeur d'Alene, Idaho. |
| 10.21(5) | Teleradiology Services Agreement, dated November 1, 2004, as amended, between Nighthawk Radiology Services, LLC and Regents, University of California. |
| 10.22(2) | Business Lease, dated December 1, 2005, between Nighthawk Services GmbH and PSP Management AG for property in Zurich, Switzerland. |

Table of Contents

| Exhibit | |
|----------------|---|
| Number | Description |
| 10.23(6) | Building Lease, dated May 12, 2006, between Nighthawk Radiology Services, LLC and WT 215 North Water, LLC for property in Milwaukee, Wisconsin. |
| 10.24(7) | Letter Agreement, dated May 24, 2006, between the registrant and Ernest Ludy. |
| 10.25(7) | Board Advisor Agreement, dated June 23, 2006, between the registrant and William G. Bradley, M.D. |
| 10.26(8) | Underwriting Agreement, dated October 25, 2006, between the registrant and Morgan Stanley & Co. Incorporated, Banc of America Securities LLC, Cowen & Co., LLC, Piper Jaffray & Co., Montgomery & Co., LLC. |
| 10.27(9) | Office Lease, dated November 20, 2006, between NightHawk Radiology Services, LLC and Quatro Investments. |
| 10.28(10)* | Employment Agreement, dated January 8, 2007, between the registrant and Mr. Timothy Mayleben. |
| 10.29(11) | Office Lease, dated January 5, 2007, between NightHawk Radiology Services, LLC and Four Embarcadero Center Venture. |
| 10.30 | Share Purchase Agreement, dated February 9, 2007, among the registrant, Teleradiology Diagnostic Service, Inc., Wilson W. Wong, P.C. and related parties. |
| 10.31* | Board of Directors Compensation Policy |
| 21.1 | Subsidiaries of the registrant. |
| 23.1 | Consent of Deloitte & Touche LLP. |
| 24.1 | Power of Attorney (contained on the signature page hereto). |
| 31.1 | Certification of Principal Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of Principal Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

- (1) Incorporated by reference to the Registration Statement on Form S-1 (No. 333-128820) filed by the registrant on October 5, 2005, as amended.
- (2) Incorporated by reference to the Registration Statement on Form S-1 (No. 333-128820) filed by the registrant on December 22, 2005, as amended.
- (3) Incorporated by reference to the Registration Statement on Form S-1 (No. 333-128820) filed by the registrant on January 24, 2006, as amended.
- (4) Incorporated by reference to the Registration Statement on Form S-1 (No. 333-128820) filed by the registrant on November 25, 2005, as amended.
- (5) Incorporated by reference to the Registration Statement on Form S-1 (No. 333-128820) filed by the registrant on November 8, 2005, as amended.
- (6) Incorporated by reference to Form 8-K (No. 000-51786) filed by the registrant on May 15, 2006.
- (7) Incorporated by reference to Form 8-K (No. 000-51786) filed by the registrant on June 26, 2006.
- (8) Incorporated by reference to Form 8-K (No. 000-51786) filed by the registrant on October 27, 2006.
- (9) Incorporated by reference to Form 8-K (No. 000-51786) filed by the registrant on November 24, 2006.
- (10) Incorporated by reference to Form 8-K (No. 000-51786) filed by the registrant on January 11, 2007.
- (11) Incorporated by reference to Form 8-K (No. 000-51786) filed by the registrant on January 11, 2007.

* Indicates a management contract or compensatory plan or arrangement.

Table of Contents**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned on the 5th day of March 2007, thereunto duly authorized.

NIGHTHAWK RADIOLOGY HOLDINGS, INC.

By: /s/ PAUL E. BERGER, M.D.
Paul E. Berger

President and Chief Executive Officer

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Paul E. Berger, M.D. and Paul E. Cartee and each of them, with full power of substitution and resubstitution and full power to act without the other, as his or her true and lawful attorney-in-fact and agent to act in his or her name, place and stead and to execute in the name and on behalf of each person, individually and in each capacity stated below, and to file, any and all documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing, ratifying and confirming all that said attorneys-in-fact and agents or any of them or their and his or her substitute or substitutes, may lawfully do or cause to be done by virtue thereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated and on the dates indicated.

| Signature | Title | Date |
|---|---|---------------|
| /s/ PAUL E. BERGER, M.D. Paul E. Berger, M.D. | President, Chief Executive Officer and Director (Principal Executive Officer) | March 5, 2007 |
| /s/ TIMOTHY M. MAYLEBEN Timothy M. Mayleben | Executive Vice President, Chief Operating Officer and Director | March 5, 2007 |
| /s/ CHRISTOPHER R. HUBER Christopher R. Huber | Chief Financial Officer, Vice President of Operations and Director (Principal Financial Officer) | March 5, 2007 |
| /s/ JON D. BERGER Jon D. Berger | Vice President, Sales, Marketing and Business Development and Director | March 5, 2007 |
| /s/ DAVID J. BROPHY, PH.D. David J. Brophy, Ph.D. | Director | March 5, 2007 |
| /s/ PETER Y. CHUNG Peter Y. Chung | Director | March 5, 2007 |
| /s/ ERNEST G. LUDY. Ernest G. Ludy | Director | March 5, 2007 |

Table of Contents**EXHIBIT INDEX**

| Exhibit | |
|----------------|--|
| Number | Description |
| 3.1(1) | Form of Amended and Restated Certificate of Incorporation of the registrant. |
| 3.2(1) | Form of Amended and Restated Bylaws of the registrant. |
| 4.1(2) | Form of registrant's common stock certificate. |
| 4.2(1) | Registration Agreement, dated March 31, 2004, between the registrant and certain holders of the registrant's common stock as named therein. |
| 10.1(1) | Form of Indemnification Agreement to be entered into between the registrant and its directors and officers. |
| 10.2(1)* | 2004 Stock Plan. |
| 10.3(1)* | Form of Stock Option Agreement under the 2004 Stock Plan. |
| 10.4(3)* | 2006 Equity Incentive Plan. |
| 10.5(3)* | Form of Stock Option Agreement under the 2006 Equity Incentive Plan. |
| 10.6(1)* | Employment Agreement, dated March 30, 2004, between the registrant and Paul E. Berger, M.D. |
| 10.7(1)* | Offer Letter with Christopher R. Huber, dated March 31, 2004. |
| 10.8(1)* | Offer Letter with Jon D. Berger, dated March 31, 2004. |
| 10.9(1)* | Professional Services Agreement, dated February 1, 2004, between Nighthawk Radiology Services, LLC and Paul E. Berger, M.D. |
| 10.10(1)* | Consulting Agreement, dated June 9, 2004, between the registrant and William G. Bradley, M.D. |
| 10.11(1) | Loan and Security Agreement, dated April 20, 2005, among the registrant, Nighthawk Radiology Services, LLC, NRS Corporation and Comerica Bank. |
| 10.12(1) | First Amendment and Waiver to Loan and Security Agreement, dated August 25, 2005, among the registrant, Nighthawk Radiology Services, LLC, NRS Corporation and Comerica Bank. |
| 10.13(1) | Lease Agreement, dated May 1, 2005, between Nighthawk Radiology Services, LLC and Global Finance & Investment Co., Inc. for property in Coeur d'Alene, Idaho. |
| 10.13.1(4) | Lease Amendment, dated December 1, 2005, between Nighthawk Radiology Services, LLC and Global Finance & Investment Co., for property in Coeur d'Alene, Idaho. |
| 10.14(1) | Lease Agreement, dated August 11, 2004, among the registrant, Stanley D. Moore and Judith K. Moore for property in Coeur d'Alene, Idaho. |
| 10.15(1) | Sublease Agreement, dated October 14, 2003, among Nighthawk Radiology Services, LLC, Commonwealth Funds Management Limited and BT Funds Management Limited for property in Sydney, Australia. |
| 10.16(1) | Sublease Agreement, dated October 1, 2004, among Nighthawk Radiology Services, LLC, Commonwealth Custodial Services Limited, Commonwealth Funds Management Limited and Investa Properties Limited for property in Sydney, Australia. |
| 10.17(1) | Lease Agreement, dated September 1, 2004, between NightHawk Radiology AG and PSP Real Estate for property in Zurich, Switzerland. |
| 10.18(1) | Lease Agreement, dated February 25, 2004, between Nighthawk Radiology Services, LLC and Demco Wisconsin 5 for property in Milwaukee, Wisconsin. |
| 10.19(1) | Agreement and Plan of Merger and Reorganization, dated September 30, 2005, among the registrant, ATN Merger Sub, Inc. and American Teleradiology Nighthawks, Inc. |
| 10.20(5) | Lease Agreement, dated October 18, 2005, between Nighthawk Radiology Services, LLC and Miller Stauffer Properties, L.L.C. for property in Coeur d'Alene, Idaho. |
| 10.21(5) | Teleradiology Services Agreement, dated November 1, 2004, as amended, between Nighthawk Radiology Services, LLC and Regents, University of California. |

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-K

- 10.22(2) Business Lease, dated December 1, 2005, between Nighthawk Services GmbH and PSP Management AG for property in Zurich, Switzerland.

Table of Contents

| Exhibit | |
|----------------|---|
| Number | Description |
| 10.23(6) | Building Lease, dated May 12, 2006, between Nighthawk Radiology Services, LLC and WT 215 North Water, LLC for property in Milwaukee, Wisconsin. |
| 10.24(7) | Letter Agreement, dated May 24, 2006, between the registrant and Ernest Ludy. |
| 10.25(7) | Board Advisor Agreement, dated June 23, 2006, between the registrant and William G. Bradley, M.D. |
| 10.26(8) | Underwriting Agreement, dated October 25, 2006, between the registrant and Morgan Stanley & Co. Incorporated, Banc of America Securities LLC, Cowen & Co., LLC, Piper Jaffray & Co., Montgomery & Co., LLC. |
| 10.27(9) | Office Lease, dated November 20, 2006, between NightHawk Radiology Services, LLC and Quatro Investments. |
| 10.28(10)* | Employment Agreement, dated January 8, 2007, between the registrant and Mr. Timothy Mayleben. |
| 10.29(11) | Office Lease, dated January 5, 2007, between NightHawk Radiology Services, LLC and Four Embarcadero Center Venture. |
| 10.30 | Share Purchase Agreement, dated February 9, 2007, among the registrant, Teleradiology Diagnostic Service, Inc., Wilson W. Wong, P.C. and related parties. |
| 10.31* | Board of Directors Compensation Policy, dated February 14, 2007 |
| 21.1 | Subsidiaries of the registrant. |
| 23.1 | Consent of Deloitte & Touche LLP. |
| 24.1 | Power of Attorney (contained on the signature page hereto). |
| 31.1 | Certification of Principal Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of Principal Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

- (1) Incorporated by reference to the Registration Statement on Form S-1 (No. 333-128820) filed by the registrant on October 5, 2005, as amended.
- (2) Incorporated by reference to the Registration Statement on Form S-1 (No. 333-128820) filed by the registrant on December 22, 2005, as amended.
- (3) Incorporated by reference to the Registration Statement on Form S-1 (No. 333-128820) filed by the registrant on January 24, 2006, as amended.
- (4) Incorporated by reference to the Registration Statement on Form S-1 (No. 333-128820) filed by the registrant on November 25, 2005, as amended.
- (5) Incorporated by reference to the Registration Statement on Form S-1 (No. 333-128820) filed by the registrant on November 8, 2005, as amended.
- (6) Incorporated by reference to Form 8-K (No. 000-51786) filed by the registrant on May 15, 2006.
- (7) Incorporated by reference to Form 8-K (No. 000-51786) filed by the registrant on June 26, 2006.
- (8) Incorporated by reference to Form 8-K (No. 000-51786) filed by the registrant on October 27, 2006.
- (9) Incorporated by reference to Form 8-K (No. 000-51786) filed by the registrant on November 24, 2006.
- (10) Incorporated by reference to Form 8-K (No. 000-51786) filed by the registrant on January 11, 2007.
- (11) Incorporated by reference to Form 8-K (No. 000-51786) filed by the registrant on January 11, 2007.

* Indicates a management contract or compensatory plan or arrangement.